The Financial System Under Stress

An architecture for the new world economy, 1

edited by Marc Uzan

CONTRIBUTORS

Zhiyuan Cui, Paul De Grauwe, Jürgen von Hagen, David Hale, Harold James, Reimut Jochimsen, Ronald McKinnon, Chris Stals, Roberto Mangabeira Unger and Marc Uzan

ROUTLEDGE

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1

Edited and with an introduction by

Marc Uzan

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Dedicated to Jacob, Arlette and Serge

This book is dedicated to my parents
and my beloved brother Serge who left us so early.
I miss them.

Marc Uzan

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FOREWORD

OBJECTIVES OF THE REINVENTING BRETTON WOODS COMMITTEE

Recent developments including the Mexican crisis, Exchange rate instability and the efforts to develop European Monetary Union have highlighted the need for coordinated responses and aims:

- What kind of reserve asset will the world be needing in the twenty-first century? This research needs to be carried out in a decentralized way by integrating industrialized countries as well as emerging economies.
- An interagency to achieve an orderly resolution to debt problems. The new international architecture must incorporate procedures to allow official debtors and private creditors to negotiate solutions to problems which retain market incentives while insuring appropriate policy responses through conditionality.
- The goal of the Reinventing Bretton Woods Committee is to create an ongoing consultation process between governments and markets by focussing primarily on the challenges of integrating private markets into the new global architecture.
- The Reinventing Bretton Woods Committee will provide important resources to assist in the management of the monetary regime by establishing:
  - An international network representing policy-makers, monetary authorities and financial markets participants to cooperate on financial market stability.
  - An information depository on emerging economies and all aspects of capital markets.
  - A link between the private sector and the Bretton Woods Institutions to disseminate economic data from emerging economies.
- The Reinventing Bretton Woods Committee is a non-profit organization. Address: 7 Park Avenue Suite 101, New York NY 10016

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INTRODUCTION

THE WORLD ECONOMY AT THE TURN OF THE CENTURY

The search for a new paradigm 1944–95

*Marc Uzan**

BACKGROUND

The fiftieth anniversary of the Bretton Woods Conference seems an appropriate time to reassess the Bretton Woods institutions. The collapse of the European Monetary System has exposed the need to rethink international institutions and their role in the next century. Simultaneously, as economic upheavals continue in Eastern Europe and Russia, the role of private capital flows around the world must be reassessed. These events, combined with the waning influence of individual nations, have led to a call for a new Bretton Woods agreement—one that will adapt international institutions to a rapidly changing global monetary system.

The spirit of the Bretton Woods Conference in 1944 was international and focussed on long-term reconciliation. Participants in the Conference established a body of rules and set of institutions which remain important fifty years later. But since the end of the Cold War there has been no formal peace conference on the scale of the original Bretton Woods meeting to discuss how to create a new world order. The G7 summits, trade negotiations and other forums examine the challenges on a piecemeal basis only. This fragmented process of consultation cannot begin to address contemporary issues as effectively as the Bretton Woods Conference, which laid the foundation for unparalleled prosperity during the decades after 1944.

The post-Second World War period was one of far-reaching structural and institutional change. Major global initiatives included the Marshall Plan, the European Payments Union, the European Coal and Steel Community, the International Monetary Fund, the World Bank and the General Agreement on Tariffs and Trade.

One must question how significant the Bretton Woods institutions actually were in relation to domestic policies and growth in Western Europe. The

IMF and the World Bank arguably played marginal roles in the recovery process. In particular, how important were the Bank's reconstruction loans in 1947, and what were the implications of the Bretton Woods system for price stability after convertibility was re-established in 1958?

The system of international economic institutions devised at Bretton Woods is beginning to show its age. There is a growing perception that the institutional arrangements designed in 1944 are inadequate for managing today's international economy and that a comprehensive rethinking of how we manage the world economy is critical.

PRESENTATION OF THE CHAPTERS

To commemorate the fiftieth anniversary of the Bretton Woods Institutions, I decided in January 1994 to form a committee comprised of scholars, markets participants and policy-makers to undertake a re-examination of the current monetary system.

The chapters which follow were presented as papers at the First Conference of the Reinventing Bretton Woods Committee.

Our goal for this first conference, held in September 1994 in New York, was the emergence of a blue print which would provide methods for implementing our recommendations. This first volume to evolve from the conference, deals with exchange rate arrangements for the twenty-first century. The creation of this collection in the search for the new architecture of the world economy will provide the intellectual tools to create an institutional architecture as modern as the financial markets.

The second volume of the collection will deal with the questions of Mexico's crisis, an international Bankruptcy Court to deal with the debt crisis, the role between international institutions, and will establish a code of conduct for emerging economies in the financial market place.

The thesis of Roberto Unger has a critical part and a constructive part. The critical part claims that we can identify two crucial problems in the design of the present system. The first problem is the confusion of three missions, with the result that each is inhibited by their relationships with each other. The mission of maintaining world trade flows against balance of payment difficulties is confused with the mission of rescuing countries in crises that interrupt growth. The second crucial difficulty that Unger identifies in the design of the present system is that the unitary and bureaucratic character of the Bretton Woods organizations prevents both the turnaround and the development support missions from being executed successfully.

Unger suggests that the institutions should be desegregated and that the agenda should be multiplied. The IMF would have a narrow mission of preserving the fundamental requirements of open world trade against extreme monetary instability and balance of payments crises.

The turnaround mission, defined as the work of rescuing countries from crises that interrupt economic growth, is connected to a process of social and economic reorganization. The development mission and the turn-around mission should not be performed by unitary bureaucratic organizations but instead by competing multiple and overlapping entities.

Professor Harold James examines a number of shifts in the functions and the activities of the IMF. To use the theme of the conference, the IMF appears a rather flexible institution whose role seems to have been actually reinvented on a number of occasions so that it has come to play a very different part than the one originally envisaged. James emphasizes a new role for the IMF which is to provide information. The IMF is not considered a static institution, but as a constantly evolving organization. The question is, therefore, if we have multiple IMFs, should we necessarily have competition between them and what will be the result of such competition?

The chapter by Zhiyuan Cui entitled "International Chapter 11 and SDR" is a further development of the theme presented by Jeffrey Sachs on a Chapter 11 process for the global financial system today. The existence of a Chapter 11 reorganization bankruptcy court at an international level should come from a special joint right on unconditional concession. This special joint right should be the principal basis for an international asset, the Special Drawing Right (SDR).

The analogy between private bankruptcy proceedings in any domestic country should not be taken further in the international scene for two reasons. First, a country has an option which a firm does not have, namely to stop paying. If firms stop paying, under the same laws which apply to bankruptcy proceedings, they also apply to liquidation proceedings. And the firm can be taken over and liquidated. There is no way to take over and liquidate an economically knocked-out country. Second, one creditor not covered by the bankruptcy law is the International Revenue Service in the United States. The problem with making the analogy internationally is that the creditors are very often governments. It is impossible to imagine an international organization to appropriate national funds.

The chapter by Reimut Jochimsen focusses on monetary and currency in exchange rate issues—of regionalism versus globalism, rather than trade capital flows and intellectual property issues. Jochimsen's conclusion warns against excessive optimism with regard to a deeper effective cooperation. A return to a regime of worldwide fixed exchange rates or tripolar exchange rate target zones has no realistic basis today or in the foreseeable future.

David Hale's chapter looks at the question that we have a very unique and historic challenge to reintegrate 3 billion people who have not been active members of the global market place for most of the modern period. Today we have a new world order in which we have many more players than we had in 1945. The challenge is not reconstruction or rebuilding after two World Wars and a Great Depression. It is a reintegration. The aim is to create institutions and roles that will help to accommodate the return of 3 billion people to the world market place for goods and capital after a very long period of total absence in this field.

Professor Ronald McKinnon interprets his assignment broadly and looks to what is desirable for the international monetary systems as a whole. Rather than returning to a system of fixed exchange rates, what the world needs as a new monetary standard is actually a set of rules for coordination, which might at some point agree to exchange rates fixtures, by converging to a system of fixed exchange rates. And it seems that there is a general principle to keep in mind embodied in that approach, which is that we ought to think about where we would like to get to and then design our institutions so that they help us to get to that point, rather than start with the institutions and figure out what we ought to do with them. The chapter looks at the core of the international financial system, the United States, Japan, Europe and the relationship among these leaving the rest of the world with the expectation that over time and depending on the circumstances of each individual country they would increasingly integrate themselves into the core.

The international monetary system is now managed mainly by the major industrial countries of the world. That would be within the G7 or perhaps only in the G3. More than 170 of the member countries of the International Monetary Fund are therefore excluded from the actual management of the system. Nevertheless, many smaller countries in the world all have a vested interest in international financial stability. Christian Stals points out in Chapter 7 that it might be of some advantage for these countries to also seek closer cooperation amongst themselves in regional monetary cooperation agreements. The monetary cooperation in Southern Africa provided but one example of an effort by a few smaller countries to study a more special financial arrangement for intra-regional trade and financial flows.

In order to explore the myriad of choices for Europe on the monetary side Professor Jürgen von Hagen set up three scenarios for monetary union. Scenario One suggests monetary union with highly integrated financial markets and an integrated approach to monetary policy. This includes currency and a fairly low level of regulatory intervention into financial markets. Scenario Three is the opposite, a monetary union with multiple currencies tied together by fixed exchange rates; a disintegrated approach to policy, therefore. This attempts to leave as much autonomy to the national central bank as possible with a high level of regulatory itnervention. Scenario Two is somewhere in between.

How does one organize the transition to a true monetary union? The author proposes a gradual approach, whereby some core countries would gradually converge, they would set up institutions to help them gradually do this. The problem with this approach is that the whole idea of gradual convergence considers the world as being set so that no major shocks will occur anymore during this whole process. The second problem is the political economy of monetary union in Europe. Germany has a position of hegemony in European monetary affairs. An attempt to reduce this hegemony in monetary affairs would increase the input of the other countries in Europe's monetary affairs.

Professor Paul De Grauwe's chapter also relates to exchange rates in search of fundamental variables. One of the most perplexing features of the foreign exchange market in the last few years has been that the link between fundamentals and exchange rates has been very tenuous. We may have to stop thinking that all these exchange rates movements are related to fundamentals.

> As we approach the threshold of the 21st century we are conscious of our responsibility to renew and revitalize these institutions and to take on the challenge of integrating the newly emerging markets democracies across the globe.
>
> To carry out this responsibility we have agreed that, in Halifax next year, we will focus on two questions: (1) how can we assure that the global economy of the 21st century will provide sustainable development with good prosperity and well-being of the people of our nations and the world? (2) What framework of institutions will be required to meet these challenges in the 21st century? How can we adapt existing institutions and build new institutions to ensure the future prosperity and security of our people?[1]

The communiqué of the G7 summit in Naples, cited above, is itself an agenda and expresses the need for a collection called "A New Architecture for the World Economy". A world economic conference should address the questions raised by this document. The G7 will not be able to dictate its architecture for the rest of the world, where more than 180 countries exist today. All countries must share the responsibility for global prosperity.

The Reinventing Bretton Woods Committee presents here an agenda to provide a blueprint for action among the G7 countries and others groups during the following year. The agenda is divided into three main issues:

1 the role of the Bretton Woods institutions and their relations with the newly created World Trade Organization;
2 the search for world economic governance;
3 the integration of private markets in the new architecture as proposed.

MARC UZAN

POINTS FOR REFLECTION

Bretton Woods institutions in the context of the globalization of financial markets

The International Monetary Fund

- The 1980s and 1990s saw the most significant structural changes in financial markets of this century. The transformations have been similar to the globalization of capital markets in the late nineteenth century (1870–1914), when London was the world's financial center. The current globalization of financial markets has permitted developing countries to access more easily the flow of private capital.
- Fifty years after the creation of the Bretton Woods institutions, is the International Monetary Fund still relevant? Does it have a viable role to play in a context of the globalization of financial markets?
- Globalization carries many implications for the Fund, including the increasing unification of financial markets and the interdependence of the global economy. It is possible to increase surveillance as the primary function of the Fund and to deepen its work on capital markets so that it may contribute to better economic policies and more effective cooperation. But is it possible to provide a more reliable early warning system in the case of an exchange rate crisis?
- The International Monetary Fund was created both to supervise the system of fixed but adjustable exchange rates and to support that system as a lender of last resort. This system collapsed in 1973 when the major players turned to a system of floating exchange rates. Changes in the world economy have had their impact on both functions of the IMF. The explosion of private capital flows in a global marketplace suddenly freed from exchange controls made the Fund's role as a lender of last resort irrelevant for countries that accounted for three-quarters of world trade.
- The Bretton Woods system worked well because the United States was single-handedly prepared to direct and maintain it. When the world became multipolar the USA was not able to perform that role any more.
- Today, we must ask how the Fund can receive a new political mandate and how it may become the principal forum for multilateral surveillance and coordination of nations' fiscal and monetary policies. No system has been devised for multilateral coordination of macroeconomic policies. This role has been performed not by the Fund but by groups of major industrial countries such as the G7.
- The G7 is no longer viable for an architecture of cooperative international economic governance. Global interdependence requires that coordination take place as a firm part of a truly multilateral process.

- The world needs a credible international safety net which, by preserving the freedom of capital markets, will prevent any financial crises. Does the International Monetary Fund act as an early warning radar for problems on the horizon? Can it disseminate its policy analysis and act as a tool for international surveillance?

The World Bank

- Since the early 1980s, World Bank lending has not increased in real terms and net resources flows have actually decreased. Today, private capital flows now amply meet the need of developing countries. The growth of international private capital markets is undoubtedly a position development for developing countries, and it is gratifying that most countries are tailoring their policies to maximize access to these flows.
- Private capital flows are concentrated in only eighteen countries. Other developing countries and economies in transition have not yet access to international private capital. Estimations indicate that net total resource flows (including development assistance, other official flows and privatesector flows) to the developing countries from the industrialized world increased 35 per cent in 1993, reaching $215 billion.
- Portfolio Equity investment tripled in 1993, and total private capital flows reached $155 billion in 1993. Foreign direct investment has surpassed official flows to become the single most important source of financing for developing countries. Increase in private flows is in large measure a response to reforms and sound economic policies of a limited number of middle-income countries in East Asia and Latin America. World Bank lending should be important in these areas.
- In this regard, we should question the effectiveness of aid. Do strong institutions, policies and procedures have to lead to an efficient use of resources? Effectiveness of aid should be used now to tackle global issues such as AIDS, migration and environmental concerns.

Relations between the World Trade Organization and the Bretton Woods institutions

- How can the World Bank and the International Monetary Fund help developing countries adjust to the effects of the agreement of the Uruguay Round and align their policies to benefit from the opportunities it offers? What level of collaboration with the World Trade Organization should be established? The Uruguay Round provided more opportunities for developing countries to integrate into the multilateral trading system.
- Investment lending might be used to support infrastructure and human resource development, and technical assistance to respond to the post

war Uruguay Round environment. Policy advice to assist countries in reformulating development strategies in the post Uruguay Round environment may be as important as bank lending.

- How may the Bank and the International Monetary Fund be called upon to provide financed support to affected individual countries to help them manage the transition to the post Uruguay Round environment?
- What kind of collaboration is possible between the newly created World Trade Organization and the Bretton Woods institutions? The question of global economic governance should be raised, and the United Nations can be included to restore its role in international economic affairs.

Global economic governance: from the G7 to the search for a new architecture and cooperation in the world economy

- What kind of global governance is needed for the world economy? The G7 is going to celebrate its twentieth anniversary and is becoming more and more unrepresentative.
- Do we need to create a World Economic Council, implied by the Security Council, to discuss the world economy?
- Integrated global financial markets exert a discipline on governments' fiscal and monetary policies and exchange rate policies. Today, the ability of governments to manage change in the international scene depends, according to Barry Eichengreen and Peter Kenen on their ability to manage it domestically: "Earlier history of Bretton Woods system made serve to focus mainly on relations among governments. When looking at recent developments it is important to focus on relations between governments and markets."[2] The International Monetary Fund and the World Bank are no longer institutions of global management. The industrial world acts independently of their policy prescriptions. Private capital markets have taken over the job of global economic management.
- The G7 would not proceed alone without consultation with the rest of the world. We need to think about the system after the Cold War. That could involve new roles for existing institutions and the creation of new institutions. Architecture of these institutions is to be taken into account and the growing integration of capital markets and the prospects that they offer for a greater efficiency. Many aspects of deep integration may also require strengthened international mechanisms to foster international cooperation.
- Can existing international institutions do the job or be modified sufficiently? Are new institutions likely to be needed and will it be beneficial to create them? Which types of policies are best dealt with through direct inter-governmental consultations? Alternatively, when are explicitly international or supranational organizations likely to be required?

INTRODUCTION

Private markets and their role in the new architecture

The growing integration of the capital markets has provided new opportunities. A profound analysis is necessary to answer the question of how to create a dialogue between capital markets and governments.

- In contrast to the commerical bank lending of the 1970s, the dominant source of private capital inflow is now largely bonds and foreign and government direct investment. These forms of inflow have been directed to some twenty middle countries in Latin America, East Asia and China. There are concerns about their sustainability. They have created problems of macroeconomic management in some countries, especially in the potential overvaluation of the real exchange rate.
- There are four main causes of private capital flow to developing countries: (1) the importance of external and domestics factors; (2) lower interest rates in industrialized countries; (3) institutional and regulatory changes in industrialized countries; and (4) country credit-worthiness.
- Over half of the flows are accounted by foreign direct investment. Commercial banks have been supplemented by bondholders, equity investors and money market funds. Eighteen countries account for 80 per cent of these inflows.
- A reversal of capital flows across the board is now more likely to be caused by a country's specific deterioration in creditworthiness rather than by international development over which the country has no control.

Two important developments resulting from the diversification of finance sources have been the internationalization of American institutional funds and the growth of the mutual fund industry.

- Emerging markets account for no more than 1 per cent of pension funds holdings, even though they account for a 6 per cent share of world stock markets' capitalization. Developing countries are expected to account for over one-third of the growth in world trade and output in the next ten years.
- Debt accounts for 40 per cent of all international private flows but, unlike the generalized commercial banks loans of the 1970s, this is mainly in the form of bond issues by about twenty of the more creditworthy developing countries. Bonds are not inherently more stable than bank loans but the creditworthiness requirement for issuing bonds reduces the risks of subsequent defaults. There is a shift from bank to non-bank sources in the mix of financing from debt to equity.
- According to World Bank sources, experience suggests that the dominant factors attracting capital inflows have been structural. Changes include trade liberalization, privatization and tax reform.

- Distribution of private capital flows has been unequal. Low-income countries have yet to benefit from increased private capital flows. The eighteen countries that have accounted for 90 per cent of the flows in the last three years are middle-income countries. China has been the largest recipient of any developing country, accounting for 24 per cent of private capital flows.[3]

Is there any risk involved? How can private markets cooperate with governments? In the architecture of the world economy, it is not possible to rule out the role of financial markets. They have a stake in the good functioning of the world economy.

The risk today is shared much more widely among a range of investors, including non-bank corporations and individuals. In this regard, should international economic institutions shift their emphasis from the provider of financial resources, though it remains important to coordinate advice to policy-makers?

The globalization of financial markets has altered fundamentally the reality of the world economy. An historical perspective will be useful in this respect. During the period of 1870–1914 the world economy was far more integrated than during the 1990s. What kind of lessons can we learn for today?

From our point of view, the 1990s will be remembered as the decade when the architecture for the twenty-first century was prepared.

NOTES

* Marc Uzan is the Executive Director of the newly founded Reinventing Bretton Woods Committee in New York. In 1994 he began to form a group of distinguished scholars, government officials and business leaders with the intention of fostering a vigorous re-examination of the current monetary system. The Committee's key priorities are the establishment of an institution that will act as a catalyst between private investors and governments, and to develop ultimately a new architecture for the world economy.

Marc Uzan was raised and educated in France. He received his BSc in Economics and his Masters in International Finance from the University of Paris-Dauphine, France. After completing his degrees he began work on his PhD, which led him to the United States five years ago where he studied as a visiting scholar at the University of California at Berkeley. Marc Uzan has authored numerous academic papers and articles for institutions including studies of the global economy and international finance. He has also served as consultant to government and financial institutions, including the World Bank, la Caisse des Dépôts, the French Ministry of Foreign Affairs, France Télécom and the French Bankers Association.

1 Summit communiqué, G7 summit in Naples, 9 July 1994.
2 Kenen, P. (ed.) (1994) *Managing The World Economy,* Institute for International Economics.
3 Data from World Bank Annual Report, September 1994.

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THE REALLY NEW BRETTON WOODS

Roberto Mangabeira Unger

DISCONTENTS AND SUPERSTITIONS

The animating impulse of this proposal for the reconstruction of the Bretton Woods system is the belief that the world economy needs more, not less, of all the benefits Bretton Woods was designed to provide through international coordination and supranational institutions. However, the world cannot get what it needs without a much bolder set of institutional innovations in the arrangements for international economic coordination than the global staffer class and its political patrons have so far been willing to countenance or even to imagine. There are two main problems with the present design.

The first problem is that in the aftermath of the breakdown of fixed-parity exchange the practices of the IMF have come to confuse the fundamental but minimalist task of keeping the world economy open in the presence of the balance of payments difficulties with the work of national turnaround—helping to rescue developing countries, or countries in radical transition, from bankruptcy and chaos. The result has been the system of the conditionality agreements: too meddlesome in some respects yet not meddlesome enough in others. This turnaround task, for its part, has been confused with the practice of fundamental development assistance. The consequence has been a failure of the World Bank to arrive at a credible and effective understanding of its mission.

The second trouble with the present system is that the unitary and bureaucratic character of the Fund and the Bank inhibit the fulfillment of both the turnaround and the developmental missions. The Bretton Woods organizations cannot act without taking sides in the contention among alternative national development strategies. To avoid taking sides too much—or to conceal the extent to which they do take sides—they find themselves forced to strike a paralyzing balance between interventionism and self-restraint. At the same time, the threshold responsibility of moderating the effects of transitory exchange rate volatility and balance of payments crises upon the world trading system becomes compromised by its association with more controversial activities.

The solution—I argue—is to disaggregate tasks and multiply agents. The threshold job should continue to be done by a far smaller and less interventionist version of the IMF. However, the turnaround and the development work should be undertaken by a multiplicity of competitive organizations, equipped financially, technically and intellectually to experiment with alternative assistance practices and to support alternative development strategies. Experimentalism and pluralism should take the place of dogma and uniformity.

These proposals stand in sharp opposition to the idea of gradual movement toward a world central bank, which, under unified bureaucratic direction, would combine the responsibilities I seek to distinguish. Like the staffs of the Bretton Woods organizations of today, such a bank would be doomed to live in a twilight world, shut off from the bright lights of uncompromising science and democratic politics. Unlike science, it would cling to consensus. Contrary to democratic politics, the consensus from which it drew life would remain undisciplined by open conflict.

In addressing the sources of trouble I have described, the argument of this paper makes two main intellectual moves. The first move is the generalization of supposedly specific problems. For example, "soft-budget constraint" issues, attributed to command economies, turn out to be pervasive in contemporary economic life. A chain of analogies (and disanalogies) links turnaround problems in firms and in whole national economies, in poor countries and in rich countries. The second intellectual move is the extension to the public institutional framework—in this case, the framework of multinational or supranational institutions—of the themes of competitive pluralism we more often associate with market economies.

THE NEW REFORMERS AND THEIR AGENDA

Sachs and others have suggested that the Bretton Woods institutions in general, and the IMF in particular, should assume the role of international turnaround agents—a worldwide Chapter 11 (the part of American bankruptcy law dealing with debtor-in-possession reorganization as an alternative to the outright liquidation of a firm). The turnaround job would complement the development-assistance task to be undertaken, evermore decidedly, by the World Bank. It would help to shape an economic environment in which development assistance can prove effective. Such a program would supply the missing rationale for conditionality agreements in the long aftermath of the collapse of the fixed-parity system. It would also clarify the de facto allocation of functions between the Fund and the

Bank. Finally, it would provide suport for efforts to assert greater independence on behalf of the Bretton Woods institutions and their staffs.

Discussion of this view helps to probe the limits and the contradictions of ideas and attitudes that are making a strong bid to become the working philosophy of the new Bretton Woods. Not new enough is my conclusion. Let me call it the emerging view.

The discussion advances in four steps. First, I comment on the pervasiveness of turnaround and soft-budget constraint problems in contemporary national economies. There are significant disanalogies betweeen the way these problems present themselves in national and international settings. The second stage of the analysis shows how and why the emerging view fails adequately to recognize these disanalogies. The emerging view would grant a measure of power to a centralized international technocracy that is politically illegitimate, practically unfeasible and lacking in coherent intellectual foundation. The third step in the argument explores the implications of ineradicable conflict over economic institutions and economic growth paths for the work of international institutions. The fourth part of the paper outlines the affirmative, more radical program of reconstruction of the Bretton Woods system that is implicit in my critical account.

FIRMS AND COUNTRIES: FLAWED ANALOGIES

The problem of selective turnaround and of soft-budget constraints is omnipresent in contemporary economies.[1] For one thing, as a matter of both law and practice, firms are rarely allowed to suffer instant death as soon as they touch some hypothetical red line; the wastage of wealth and welfare in such inexorable punishment would be intolerable. For another thing, the red line is itself indistinct and moveable, generated as it is out of contingent legal arrangements about property, bankruptcy and relations among firms, banks and central banks. We cannot answer the questions: when and how to rescue firms, at what cost, and through which agents, by inferring rules and solutions from the abstract concept of a market economy. From the abstract concept we can infer only other equally empty and indeterminate abstractions. These are practical choices among competing interests and competing visions, and they are characteristically constrained by a very circumscribed understanding of alternative institutional arrangements.

Whole national economies may also need turnaround. There are, nevertheless, substantial dissimilarities from the turnaround of firms within a national economy. The emerging view comes to grief on some of the implications of these differences. Until we do justice to these differences the comparison to domestic debtor-in-possession reorganization remains a metaphor in the service of the illusion.

First, there is no uniform legal-institutional environment throughout the world, despite the orthodox hope of worldwide convergence toward the same institutions. The effective forms and the social and economic consequences of turnaround differ according to the legal-institutional context in which it takes place.

Second, national turnaround is directly linked to the controversial and conflictual problems of alternative national development strategies. The history of the disputes over the conditionality agreements of the IMF is, among other things, a history of confrontations between clashing development strategies and between conflicting programs of institutional change. The test of success for turnaround in governments and economies is far less clear and more contentious than the standard of success for turnaround in firms. The financial solvency that matters to governments is the one that brings a country to the threshold of a growth path it wants and can sustain.

Third, turnaround decisions in an international setting are not made by judges, bankers, creditors and debtors according to economic calculation and impersonal law. They are made by a supranational technocracy, largely funded and supported by the leading economic powers, relying upon economic ideas that are dominant but contested, and acting through a combination of rules-of-thumb and discretionary judgments.

BRETTON WOODS IN THE SERVICE OF DOGMA

The collapse of gold and fixed parity pushed the IMF and, by extension, the whole connected system of Bretton Woods institutions deeper into an uncharted sea of ideological and practical conflicts. It did so under the barely concealed disguise of alledged technical necessities. The full-scale and overt assumption of the turnaround role by the IMF and the World Bank would aggravate the conflicts while reinforcing the powers of the international economic technocracy and of the interests and ideas to which it has bound its fate.

Consider the infirmities of such a development. First, the centralized rescue machinery would enjoy little political legitimacy. It would be conducted by unelected officials under bureaucratic control. It would rely heavily upon big-power interests and controversial political-economic doctrines.

Second, it would be fiercely contested and its operations would be likely to become all the more what even the conditionality agreements of the IMF have already often been: the subject of bitter quarrels within national economies. The contest would probably be most ardent in the large marginalized countries—China, Russia, India, Indonesia, Brazil—according to the vicissitudes of national politics in each of them.

Third, this reconstructive mission would rest upon shaky intellectual foundations. It would represent a form of bureaucratic interventionism in real markets. Yet it would be a peculiarly truncated or arrested interventionism, given the centralized, controversial and relatively unaccountable character of the institutions serving as its instruments.

It is interesting to reconsider these problems from the standpoint of the proposals discussed, and the experiences undergone, during the foundational era of the Bretton Woods regime. Both the White Plan and Keynes' rival scheme for an International Clearing Union limited the discretion to be accorded the newly empowered technocracy: the White Plan, by tying this discretion to the mechanics of gold-based fixed parity; Keynes' blue-print, by appealing to relatively automatic rules and practices such as traders might use in a private clearing system. Despite these precautions, Keynes remained obsessed with the need to guarantee the practical political autonomy of the international technical experts who would be the enlightened agents of the moderate interventionism he favored.

Nothing is more revealing of the dependence of institutional proposals upon unavoidably controversial doctrines than the way in which the rules of Keynes' ICU exhibited his characteristic concern to rescue the overspenders and to punish the oversavers in international trade. It is equally suggestive that the Marshall and the Dodge Plans—described by McKinnon as far more successful than the Bretton Woods institutions themselves—succeeded precisely because they did not need to feign impartiality or detachment. As schemes imposed by the victors upon the vanquished (as well as upon the impoverished victors) they conformed to clearly stated and comprehensive development strategies. The institutional vehicle imposed no constraint upon the substantive program, nor did the substantive program burst the limits of its institutional agent.

Nevertheless, when all is said and done, the world needs arrangements for international turnaround just as it needs development support. How can it get what it needs without having to please American professors of economics and French *inspecteurs des finances* as well as the United States Congress? How can it get what it needs without finding its needs victim to an unresolved conflict between an unfinished work and an unsuitable agent? The answer is: not without a more thoroughgoing reconstruction of the Bretton Woods system than the loyal opposition has so far been willing to consider.

ALTERNATIVE MARKET ECONOMIES, ALTERNATIVE DEVELOPMENT STRATEGIES

The argument about the controversial character of the turnaround and development work of the Bretton Woods organizations requires closer attention. Two theses are central to this argument. The first thesis is that conflict over economic institutions and economic growth paths is ineradicable. The second thesis is that a unitary structure of international organizations holds urgently needed international help hostage to national submission to a partisan program in this conflict. These theses have far-reaching and misunderstood implications for economic theory, for practical economic policy and for the legal structure of the world economy. We need to explore the theses and their implications further before we can understand what needs to be done. The exploration takes us through a brief detour in some conundra of contemporary theory and policy.

A familiar and frustrating set of debates in political economy develops along the following lines. Selective industrial policy and protection for emerging industries may theoretically be better than dogmatic and flexible free trade. They may enable countries to escape an unfavorable and long-lasting niche in what is supposedly a single, inescapable evolutionary path toward more productive labor. The trouble is that in practice any attempt at selective industrial and trade policy creates opportunities for collusion and rent-seeking as well as for sheer bureaucratic dogmatism and stupidity. So the activist solution that may be preferable in principle rarely turns out to be best in practice.

Similarly, multiple exchange rates (distinguishing, for example, between imports of consumer and of capital goods) may be better in theory than either a unified pegged rate or a unified floating rate. For the same reason, however, multiple exchange rates are likely to be worse in practice. A parallel discussion arises in arguments about the differential allocation of credit to industry or the use of fiscal policy to influence, differentially, decisions to save and invest.

These discussions in turn have a strong family resemblance to a second set of arguments in political economy: the attractions of facilities to risk-bearing entrepreneurial activity such as the limited-liability corporation, or the availability of debtor-in-possession reorganization as an alternative to outright bankruptcy, must be weighed against the dangers of "moral hazard"—of the inducement to reckless and inadequately disciplined economic behavior all such facilities create. The difference is that in this second class of arguments, unlike the first set, about selective trade and industrial policy or multiple exchange rates, there are no identifiable second-best solutions.

We lack a formulaic device by which to distinguish beforehand and in general terms the good risks from the bad ones, or the hero of Schumpeterian entrepreneurialism from the villain of moral hazard. Consequently, we have no escape from the need to make rough-and-ready compromises, informed by our sense of the most promising path of institutional development. We must choose the arrangements most hospitable to the whole form of life, or ideal of civilization, we seek to sustain as well as those most conducive to economic growth and innovation. We cannot disentangle the design of economic institutions from the institutional character of society as a whole.

This conclusion sheds a revealing light upon the first set of discussions— the ones about the theoretical first-best of governmental activism and the practical second-best of governmental passivity. The retreat from activism in the strategic coordination among firms, or between firms and governments, to the safety of the practical second-best of an arm's-length relation among firms or between firms and governments is neither a natural nor an eternal prescription. It is simply the consequence of the choices we must make among the institutional arrangements embodying, on one side, activism, selective policy or strategic coordination and, on the other, arm's-length market relations. In every such discussion we come in the end to the point at which we must ask whether we must indeed choose among the available forms of market relations and of strategic coordination or whether, instead, we can broaden the repertory of available institutional arrangements.

Thus, for example, the susceptibility of selective trade policy or differential credit allocation to collusive rent-seeking and economic dogmatism is not an historical constant. It depends upon the institutional tools of the activism. Some such devices may be more decentralized and participatory, and more subject to democratic accountability and competitive pressure, than others. We may have in our minds the picture of a central bureaucracy, like a Ministry of Foreign Trade or a Ministry of Industry, as the agent of the strategic coordination. However, other much less centralized arrangements may be practicable. In fact, even the existing North-East Asian economies, supposedly the most successful practitioners of strategic coordination, differ significantly in the extent to which their methods of trade and industrial policy are elitist and collusive, disfavoring the happy serendipity of market-driven experimentalism. Taiwan, for example, has enjoyed a more decentralized version of industrial and financial assistance, one more friendly to small business, than has South Korea.

These established variations are best understood as a subset of a far broader and always ill-defined range of institutional possibilities. In practice and in imagination the institutional repertory broadens by analogical extension. Thus, we may imagine a form of industrial policy having the same relation to the Taiwanese version that the Taiwanese brand has to the South Korean. As we progress along this spectrum, the pressure to move from the theoretical best of active selection, differentiation and coordination to the practical second-best of governmental passivity and rigid contrasts between cooperation and competition diminishes. The arrangements of strategic coordination become less vulnerable to hijacking by privileged interests and bureacratic know-alls. In fact, the distance between the allegedly opposing tacks of the pure market and the guided market narrows.

If we move far enough in this direction we come to the idea of strategic coordination deployed by distinct and competing agencies, accountable both to firms and to governments while enjoying substantial independence from both. Such a regime may make it possible to try out, in particular sectors of the economy, different strategies of selective help and to assess empirically the results of each. It may therefore be more open and experimentalist than a regime which reduces the relations among firms to pure competition and the relations between governments and firms to arm's-length regulation.

We arrive at a similar conclusion if we begin from the other end, thinking through the possible institutional forms of the market economy rather than the possible institutional arrangements for selective interventionism and strategic coordination. One of the major results of the work of legal thought since the mid-nineteenth century has been to demonstrate that the market economy lacks a single natural and necessary legal form. No one system of rules and rights of property and contract, or of arrangements for the corporate organization of business, or of labor-law regimes, defines a market economy. Private property itself turns out to be just a "bundle of rights." We can disassemble and recombine it in any number of ways. We can pull apart its constituent powers and vest them in different types of right-holders.

Should the form of private property in a market economy emphasize the extension of access to productive resources, preferring whatever property regime broadens such access to the greatest number of economic agents? Or should we underline instead the absoluteness of the power that each owner enjoys over the resources at his command? If the former emphasis prevails over the latter we may be led to develop a system of fragmentary, conditional or temporary property rights, sacrificing absoluteness of ownership to effective access. Should the regime of private property freely allow the hereditary transmission of wealth, with its sequel of unequal advantage and opportunity? Or should we instead develop, within the market economy, a scheme of social endowments by which individuals inherit from society rather than from their parents? Under such a plan, individuals might receive increments to the socially guaranteed minimum endowment according to the contrasting and complementary principles of rewards for competitively demonstrated capacities and compensations for authoritatively certified needs. Should there be, as we have been accustomed to think there must be, just a single system of contract and property rules? Or, as a more thoroughgoing experimentalism recommends, should different legal—institutional mechanisms for the decentralized allocation of capital coexist within the same economy? On our explicit or implicit answers to such questions depend our attitudes to the problems presented by the familiar definitions of the theoretical best solutions and the practical second-best solutions in economic policy. The position we take in such debates is no more defensible than the institutional assumptions we bring to them.

Seemingly speculative institutional possibilities come to life in the realities of national politics and in the political choice of alternative growth paths. We cannot sensibly understand what happened to Germany and Japan in the nineteenth century, or what happens to Asian "tigers" today, by treating the market economy as the object of a take-it-or-leave-it faith or by reducing our choices to a hydraulic measurement of more or less governmental intervention in the economy. Politics becomes fate by settling the institutional and imaginative context in which routine conflict and competition, innovation and growth, take place.

The dominant styles of economic analysis remain, however, powerless to penetrate this fateful institutional reality. They continue to be tainted by institutional fetishism: the unwarranted identification of the abstract idea of the market economy with a particular system of private law and a particular legal structure of relations between government and business. Institutional fetishism blinds much of the familiar discourse of economic policy to the specificity and the contingency of these legal arrangements. This fetishism prevents us from appreciating how much these arrangements are the products of chance compromises between pre-existing privileges and concessions to freedom, struck with the institutional and doctrinal materials lying at hand. The "new institutionalism" supports this prejudice because it portrays the surprising history of economic institutions as the predictable and continuous interaction between rational economic behavior and changing pre-political facts, such as population growth. It is against this intellectual background, as well as against the background of the communist collapse, that so many contemporary ideologues present the history of modern institutions as the record of a narrowing funnel of convergence worldwide toward the same economic practices and institutions.

We can now return to the suggestion that the Bretton Woods organizations perform the role of rescuing economies in trouble while promoting economic development around the world. How are they to accomplish this work without taking sides in the all-important quarrels about alternative economic institutions and alternative trajectories of economic growth? The staffs of the multilateral organizations, like the academic and bureaucratic elites of the leading powers, believe there are no sides to be taken because there is no real contest. The most explicit and aggressive expression of this belief is the idea that conformity to the time-tested institutions of the rich economies, together with the dynamic effects of incorporation into the world trading system, will lift all countries up. The doctrine derives much of its persuasive force from the near vacuity with which it defines the legal rules of the market economy as well as from a triumphalist reading of the present moment in world history. Its message is: we need only a final push beyond the gateway to global consensus and convergence.

According to this view, the IMF should come to the rescue of governments in financial trouble, so long as they stay on the right path: the path of the convergence and the consensus. Were such assurances of obedience not given, money would indeed be wasted. The comparison to domestic turn-around soon reveals its more tangible meaning: the IMF should assume more explicitly its responsibility of satisfying the conditions for the world-wide mobility of capital by preventing balance of payments crises that threaten to get in the way. Its new companion agency, the World Trade Organization, should undertake the parallel work of policing the rules for free trade in goods and services. The World Bank can carry out the subsidiary job of helping countries develop the physical, human and organizational instruments of development by proven means, directed to a well-known result.

A first sign of trouble is that even the votaries of the "Washington consensus" are liable to disagree. For example, the IMF staff has resisted the advocacy of fixed exchange rates, a mainstay of the exchange rate anchored stabilizations. When we expand the scope of our vision further we soon begin to realize that the effort to make the world safe for globally mobile capital is fraught with conflict and controversy. In the here and now there is the debate, accelerated by the Mexican crisis of December 1994 to January 1995, about the wisdom of dependence on flows of speculative and volatile foreign capital. In the longer future there is the suppressed, explosive paradox of a world economy in which capital becomes hypermobile while labor remains imprisoned in the nation-state or in regional blocs of relatively similar nation-states. The pride of such a system of free trade is to remain free by half. The half left unfree is sure to strike back.

Today in the world economy two great transformations and contests are in their youth. To understand them and to understand how they can speak to each other is to grasp the limits of the convergence thesis. It is also to see that there is no uncontroversial program of worldwide economic growth and coordination of which the Bretton Woods organizations could be the agents.

The first dispute concerns the growth paths of the developing countries. Against the operative orthodoxies of the present day there emerges the desire to find a growth plan relying primarily upon internal saving and investment, which upholds the possibility of active partnerships between government and business in the pursuit of a national development strategy and which dispenses with the costly crutch of an overvalued, fixed exchange rate as the condition of monetary stability. Such an alternative would renounce the attempt to escape politics. It would provide a minimal basis on which to confront the sources of inequality and instability in economic and social dualism, and thus to avoid a perennial and destructive pendular swing between economic orthodoxy and economic populism. The attractions and prospects of such an alternative depend upon our success in giving to governmental activism, and to the partnership between governments and firms, forms that are more decentralized and diverse, and more directly subject to the double pressures of market competition and democratic accountability, than those we have so far associated with industrial and trade policy.

The other great change and debate centers on the process of industrial reorganization now underway in the most successful regions and sectors of the advanced economies. There is a managerial program of conservative industrial renovation. Its complaints are the rigidity and the conflictual character of the present industrial system. Its first byword is flexibility, meaning more mobility for capital, achieved through more power of independent decision by the present owners and managers of capital: power, for example, to close plants or to reallocate jobs abroad. Its second byword is cooperation: teamwork to motivate workers and to organize flexible, non-standardized production. Flexibility and cooperation are in tension. To manage this tension by devices such as the segmentation of the laborforce into more stable and less stable tiers has become the most urgent concern of the conservative renovators.

The conventional social-democratic response to this program of conservative industrial renovation also has two elements. The first plank in its platform is the commitment to fight a rearguard action, through stronger claims of job tenure and rights to prevent plant closings, in defense of the threatened positions of workers. Under such a program temporary advantages become vested rights. The second part of the social-democratic answer to the managerial program of conservative renovation is to multiply the recognition of stakes and stakeholders in firms so as to include workers, consumers, local governments and a variety of organized publics. Pursued in earnest, such a program threatens to aggravate the complaints of rigidity and conflict that initially motivated the program of conservative renovation. It risks producing paralysis in economic activity. It digs into the niches of declining and besieged sectors of industry rather than laying the basis for a more solidaristic, popular alliance, connected with a long-term project of economic reconstruction.

The future of the popular and the progressive cause in the rich industrial democracies has come to depend in large measure upon the possibility of finding an alternative to this desperate social-democratic formula. For the moment, labor and social-democratic parties oscillate between the formula and the resigned acceptance of the program of conservative renovation, attenuated in its effects by the maintenance of the welfare state, the most lasting legacy of social democracy. Unable to choose between these two thorny paths, the social democrats find themselves disoriented. Their program is often the program of their adversaries, with a 50 per cent discount.

Can we find an alternative that universalizes and equalizes "flexibility," multiplying means of decentralized access to productive resources and strengthening the social endowment of economic and cultural equipment with which the individual can thrive in the midst of economic innovation and instability? To answer this question affirmatively is to begin to give a renewed, more democratized form to the market economy. A successful answer is likely to involve the development of a more decentralized and experimentalist partnership between governments and firms. Semi-independent and competing agencies, standing between firms and governments, may take the lead in providing help and coordination. They may make cultural and economic resources available on a variety of terms, experimenting with temporary, conditional and fragmentary property rights. The task of working out such a democratizing alternative to conventional social democracy turns out to be rich in analogies to the work of those who in developing countries look today for an alternative to the neoliberal project.

The world in which international financial rescue and development assistance remain urgent is a world in which these conflicts—or conflicts like these—will intensify rather than wane. Suppose the international turnaround and development-assistance missions continue to be executed by unified and centralized bureaucracies acting, more often than not, as the coordinating and certifying agents of private capital. The Bretton Woods organizations will then become evermore unabashed, although largely unaccountable, partisans in a struggle of interests and of visions. They will serve as the instruments of the dominant economic program—the one that happens at the time to be favored by the leading industrial powers and, most especially, given the hegemonic status of the United States, by American government, business and academia.

Even if you adhere to the dominant program, you may have reason to reject this result. First, it helps strangle worldwide experimentation with diverse views and strategies. Second, it forces the rebellion against the ruling prescription to turn into a revolt against the system of international economic coordination itself. Third, the staffs of the Bretton Woods organizations may well respond by oscillating between the single-minded imposition of the official creed and the appeal to halfhearted and eclectic concessions, moderating one evil by resort to another.

The solution is to distinguish missions and agents. The barebones version of the present IMF would perform the minimalist clearing-house mission described below. Decentralized and competing organizations, working on different assumptions and promoting alternative programs, would do the work of international financial rescue and development assitance, with or against international private capital. Thus, the design of the regime of international economic coordination would embody the same principle of experimental variation in the institutional devices of the market economy that the prevailing ideas in economic theory and policy so strikingly fail to respect. We do not have to choose between accepting an arm's-length relation among firms, or between firms and governments, and promoting the power of authoritarian bureaucrats to "pick economic winners." So, too, we need not choose between repudiating international efforts at financial rescue and entrusting such efforts to a centralized, bureaucratic apparatus devoted to a single program.

At the meeting at which the papers composing this book were delivered, the dead hand of supranational technocracy and academic orthodoxy rose up in defense of convergence and consensus. Even the gold standard was exhumed in the grinding quest for stability no matter what. We heard the voice of the Hegelian universal class, professing to represent no particular countries, classes, interests, ideologies or intellectual traditions, only the inexorable demands of an unyielding global progression. A ragtag band of currency traders and academic malcontents provided such opposition, offering the tenuous affinity between financial speculation and intellectual subversion as a token vestige and reminder of the restlessness outside.

A PLURALISTIC PROGRAM

Under the new Bretton Woods regime, three distinct types of institutional agents should assume responsibility for three different jobs: the clearing mission, the turnaround mission and the public venture-capital or development-support mission.

A leaner, chastened version of the present IMF should carry out the clearing mission. This is the work of preventing, through the development of payment mechanisms and the concession of bridge loans, breakdowns in trade flows resulting from exchange rate volatility and balance of payments difficulties. The system should be funded by national governmental contributions proportional to the country's participation in the world trading system. It would be appropriate for the national governments to impose much of this cost on the firms engaged in the trade and capital flows. After all, the clearing regime is an international, public machinery for generating benefits captured, disproportionately, by private agents. Two large restrictive qualifications should circumscribe the scope of this work.

First, the clearing support should not be diverted into the maintenance of preconceived exchange rates among the trading partners or intervention in the wars between central banks and currency speculators. If the major trading partners believe it to be in their interest to impose some fix on exchange rates they should do it by other means and through other agents, respecting the integrity of the clearing system.

Second, the administration of the clearing regime should not be used, in the fashion of the IMF's conditionality agreements, to police national economic policies and force them into a convergence toward the reigning consensus. Persistent balance of payments difficulties resulting from wrong-headed economic policies, or from unresolved structural problems in a national economy, should not be addressed, directly or indirectly, by the clearing system. It suffices to insist that the bridge loans be short-lived and closely linked to the preservation of trade and capital flows. Thus, unlike Keynes' International Clearing Union, this system would seek to be as neutral as possible among conflicting political-economic assumptions and strategies. It is safe to entrust such a self-denying task (but no more) to technocrats like those who run and staff the IMF of today.

The turnaround mission is the medium-term work of assisting countries struggling to overcome economic crises that interrupt growth, whether or not these crises manifest themselves in balance of payments breakdowns. Among the crises may be the tense transition from one economic regime to another, such as is experienced by the formerly communist economies of today. Help comes in the form of subsidized finance and technical advice. It also comes in the form of temporary variances, or claims for such variances, in the rules governing the international movement of goods, services, labor and capital. Before suggesting the nature of the agents and of the funding of the turnaround mission, consider the third of the three tasks to be carried out by the new Bretton Woods—the venture-capital or development job.

There is no sharp distinction between these two missions, only a relative change of emphasis, scope and time horizon. The development work is the job of helping to fund and to shape a structure of self-sustaining growth, and of doing so in ways that are relatively uninhibited by the pressure for short-term profits. If the turnaround job is imagined as an analogical extension of domestic Chapter 11, the development job can be understood by analogy to both traditional development aid and private venture capital, taken as two extreme points of a spectrum of assistance.

When working with the poorest and most backward economies its focus would be, on the model of traditional development aid, the funding of basic educational and physical infrastructure. On the other hand, when dealing with more advanced economies, or more advanced sectors of backward economies, the emphasis would fall on financial and technical support for organizations—public, private and cooperative—that would, in turn, finance and inform small and medium-sized firms. Direct assistance to firms would be exceptional and would be undertaken, when undertaken at all, for the purpose of experiment and example.

Neither the turnaround nor the developmental missions should be performed by centralized bureaucratic institutions like the IMF and the World Bank. Instead, a cast of multiple, overlapping and competing organizations should carry out each of these two missions. These organizations would be established by, and accountable to, a representative supervisory organization within or outside the United Nations system. But they would enjoy broad-ranging entrepreneurial autonomy. They would be encouraged to try out different understandings of either the turnaround or the development jobs and to experiment with different practices in the actual execution of their work. The results achieved by each could then become subjects of public assessment and debate. Cumulative experience would support some of the emerging practices while discrediting others.

Like the IMF and the World Bank of today, these organizations would be technical—neither a political nor a purely entrepreneurial apparatus. Like the existing Bretton Woods organizations, they would draw most of their cadres from the staffer class of practical academics, ex-managers and cosmopolitan bureaucrats. They would, however, be much smaller than the Bretton Woods mammoths and they would make no pretense to impartiality about doctrines and strategies. On the contrary, an experimentalist partiality, energized and controlled by pluralism, would be their whole point.

The more depoliticized and automatic the funding of such bodies, the better. Thus, supplementing the earnings of these post-Bretton Woods organizations with a worldwide tax is to be preferred to a list of national governmental contributions. Moreover, the preference should be for a tax that is relatively neutral in its consequences for investment, production and distribution and therefore less likely to operate, or to be understood, as a tilting of scales among interests or among ideologies. Thus, we might prefer a proportional surcharge to the comprehensive flat-rate value-added tax, or to the closest approximation to that tax, within each national economy. There might be two or three gross levels of surcharge according to the standing of each country in a gross ranking of comparative prosperity.

From where would the fiercest opposition to such arrangements come? Not from poor countries indignant at rich countries. Not from little countries fearful of big countries. Not from labor in confrontation with business. Not from business recalcitrant to governmental tutelage. Not from any force or class recognized in the traditional vocabulary of interest analysis. The fiercest opposition would come from the same cadres of economic bureaucrats and academics-on-leave who form the heart and soul of the Bretton Woods system today. They would hardly lack for jobs in the new Bretton Woods. It is just that they would have to give up some of the confusion of science, politics, charity and personal adventure into which, alas, they have sunk.

NOTES

1 I developed, through discussions with Zhiyuan Cui, my understanding of the pervasiveness of what János Kornai, studying the political economy of communism, first described as “soft-budget constraints.” To Professor Cui I also owe my understanding of the dilemmas of moral hazard and entrepreneurial innovation mentioned here. He is presenting in a separate paper (see pp. 57–63) an alternative programmatic response to the problems addressed in this note.

2

THE INTERNATIONAL MONETARY FUND AND THE INTERNATIONAL MONETARY ORDER SINCE 1945

An historical perspective

*Harold James**

The general evolution of the international monetary system since the Bretton Woods Conference has been a movement away from rules and toward cooperation. Increased information has played the role previously occupied by a legal or quasi-legal framework. This development constitutes the fundamental challenge, and opportunity, faced by international financial institutions. The satisfaction of this demand for the reliable provision of information and analysis will become their principal *raison d'être*.

THE HISTORICAL ARGUMENT

The construction of the postwar international monetary system came as a result of a general agreement that a repetition of the economic and political nationalism of the 1930s could and should be avoided. The interwar experience had provided a vivid and terrifying demonstration of how the collapse of the economic order could bring political and social fragmentation. In the new order, a commitment to keep stable but adjustable exchange rates would eliminate the temptation to engage in competitive devaluation. Controls on capital movements would eliminate the big speculative flows that had destroyed the exchange rate regime of the interwar period. The essential insight of the new vision was that harmonious inter-state relations involved a willingness to agree on the surrender of some aspects of national sovereignty.

The agreements produced at Bretton Woods combined a vision of a liberal world economy with a rule. The rule's primary purpose was to constrain national economic policies in cases where otherwise the interaction of different national strategies might cause disaster for the world as a whole (in currency policy, competitive devaluations; in trade policy, the application of protectionism). Apart from this, it would preserve the policymaking options ("sovereignty") of nation-states. At the time of Bretton Woods, a vivid memory of the 1930s saw the requirements of the international order as frequently in conflict with the imperative of building a more just and stable domestic order. The conference aimed at providing a solution to this dilemma. The main attraction of the rule was that it was impersonal and largely automatic. States were obliged under the terms of their legislation accepting Bretton Woods to maintain fixed exchange rates. The pursuit of inappropriate policy would lead to danger signals, in the form of balance of payments imbalances. A state could then either take corrective action (adjustment), if necessary with the assistance of the resource pool created in the International Monetary Fund; or, if it was judged that the imbalance reflected a fundamental disequilibrium, the exchange rate could be altered with the approval of the Fund. The commitment to keep the exchange rate fixed would by itself provide sufficient limitation of the room for national policy maneuver. A further function of the Fund was to create, through the quota mechanism, an additional pool of reserves (it functioned analogously to a credit union). The goal was to ensure that, in a period when outside the United States a general shortage of reserves existed, this limitation would not stand in the way of the movement to liberalized trade and exchange convertibility.

This system had a strong element of automaticity, but one which would and could never be total. The principle of surveillance by the Fund developed out of the necessity of judging whether a member country's needs and policy objectives corresponded to a situation in which the use of the Fund's resources would be appropriate; as well as out of the commitment of members to consult if they maintained the transitional regime (under Article XIV of the Articles of Agreement), in which exchange controls might still be tolerated. In other words, the Fund as a financial institution was required to use its lending to promote a specific outcome. Its resources were to be used "to facilitate the expansion and balanced growth of international trade, and contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members." The Articles of Agreement also recognized the importance of the new body in the exchange of information and views. Its purposes had already been defined as "to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems."

The basic commitment to rule-guided liberalization inherent in the acceptance of convertibility laid the foundations for a system which created unprecedented rates of economic growth and increased prosperity throughout much of the world. However, there were two major surprises. First, the new institution never controlled world liquidity (or, indirectly, the world money supply) in the way originally envisaged. As the global economy grew, IMF quotas accounted for ever smaller shares of international reserves. Even the new IMF "money" of the 1960s, the SDR, which actually reproduced quite faithfully the intentions of the founders of Bretton Woods, came to represent only a very small part of the world's reserves. Instead, national authorities, and increasingly also the substantially uncontrolled operations of the Euro-markets, created their own money.

The second development largely unforeseen at Bretton Woods—one which, in fact, contributed greatly to the dynamism of the world economy but which also altered the character of the monetary order—was the emergence of large capital movements, freeing money from national control. The original agreements had involved an obligation to liberalize current accounts, but—among other considerations—the primary rule (fixed exchange rates) involved the necessity, or at least the possibility, of controlling capital flows. When the world returned after the war to nearly general convertibility at the end of the 1950s, and accepted the corresponding Article (Article VIII) of the Fund's Articles of Agreement, this meant convertibility on current account only. However, even at this early stage, substantial capital movements developed. The access to resources they brought constituted one of the main incentives to many countries to adopt convertibility. Capital movements brought not just the possibility of increasing national investment levels and were also often associated with flows of skills and technology. This was true of Spain in the late 1950s and then of Latin American countries (where the initial experiment in convertibility was often unsuccessful) and East Asia (where some spectacular successes occurred).

As capital flows developed, the problems of monetary management became more complex. One instance of the new difficulties was the effect of capital inflows on the domestic money supply. Another example was that capital flows allowed a financing of current account deficits. Initially, current account deficits were believed to be the major problem requiring international action; but capital flows might make them less of a problem. Inflows—foreign borrowing—could offer an easy and at least temporary alternative to immediate adjustment. Obviously, such flows depend on the verdict of the lenders—the market—and cannot necessarily be maintained indefinitely (particularly if the resources are used chiefly to pay for increased consumption). The availability of capital often simply offered the possibility of making a choice about a time-frame for adjustment; but governments (with often limited political time-horizons reaching to the next elections) wanted to take advantage of such a choice by deferring the adjustment as a problem to bequeath to their successors. As a result, there were temptations not to recognize underlying economic problems. The new difficulties were the underlying rationale for the extension of IMF consultations to include also the member countries who had gone over to full convertibility under

Article VIII of the Articles of Agreement. Such consultations might give advance notice of the likely emergence of economic problems. Throughout the 1960s the international community repeatedly tried to develop a systematic approach to "early warning signs."

At the same time, the availability of funds on captial markets altered the demand for liquidity. In cases when confidence was maintained, there would be sufficient liquidity as a consequence of private lending. Such funds, however, would not be available exactly when they were needed—in a crisis. In cases where confidence disappeared, the Fund became more necessary than ever as a substitute for the private market, as a way of financing imbalances and restoring expectations of stability: in short, as a reserve center or a lender of last resort. There are two ways of providing such assistance. The first, immediate support in the case of a market panic in order to forestall an imminent market failure, is undertaken by central banks or (for many industrial countries) by the central bankers' central bank, the BIS. The second, in which policy changes as well as a persuasion of financial markets are required in order to restore confidence after a market failure has already taken place, has been the domain of the IMF. (The IMF could also potentially play a larger role in the former operation—perhaps not so much directly, by trading on its own account, but by using its resources to help to unwind the substantial swap positions built up by central banks in cases of intervention where they are not unwound as an immediate consequence of the re-establishment of confidence.)

The flows of capital brought an increasing instability to the system and eventualy destroyed the par value system between 1971 and 1973. As the instability became more apparent in the late 1960s, the transfers of funds across frontiers increased dramatically; once the system was evidently in crisis, between 1971 and 1973, they became even larger. Fixed parities might have survived somewhat longer had it not been for the temptation that a system of rules offered to some of its members to exploit the rules in order to obtain national advantage. Two countries issued the major reserve currencies. For a long time, the system had tolerated the problems of the lesser reserve currency (the British pound) and the constant problems it generated internationally, first in slowing the move to general convertibility and then, in the 1960s, in producing repeated balance of payments crises. One of the reasons for the failure to deal systematically with the problem of the pound sterling lay in the US desire, born out of a sense of solidarity between the reserve currencies, to protect the pound. The dollar's reserve role had insulated the United States from the need to undertake adjustment in the par value system; the result had also generated permanent surpluses in other countries as the counterpart of the American deficits. This US privilege had been a function of the operation of the par value system on the basis of dollar reserves; but when at the end of the 1960s the United States began to view the dollar in the same way as Britain had long treated the pound, as a national resource to be manipulated for the sake of national advantage, the system soon collapsed. Subsequently, other countries which became major issuers of reserve currencies have been frightened to use (or abuse) the system in this way and have been highly conscious of the fact that adding to international reserves through the build-up of current account deficits courts the risk of a dramatic and unpleasant reversal of confidence.

A solution to this challenge which maintained the par value system would have involved an earlier and orderly devaluation of the dollar relative to gold and other currencies; but there existed no institutional way of obliging the United States to take such a step, and at the time almost all commentators doubted whether it was possible at all. The strain on the US position increased as the other non-surplus countries implemented their own devaluations relative to the surplus economies (Germany and Japan), and they at the same time, of course, had to alter their parity with respect to gold and the dollar. Many members began to see the system not as beneficial but rather as a mechanism for forcing them to adjust and suffer from the effects of US monetary expansion. This was the basis for an attack on the US "hegemonic" position, or on what General de Gaulle called the "exorbitant privilege."

One possible way of dealing with the strains was sometimes touted in the 1960s but was, fortunately, dismissed: an imposition of capital controls. If such controls had been widely adopted they might have rescued the par value system, but they would have also severely constrained the future development of the world economy. The emergence in the 1950s and 1960s of substantial capital movements through "leads and lags" on the current account had, in any case, abundantly demonstrated the futility of such control. The desire to halt capital movements, or at least to separate "good" or "productive" from "bad" or "speculative" flows, remained quite powerful, partly because goverments wished to prevent markets exercising a vote of confidence on their policies, and partly because the adherents of a fixed-rate system saw this control as the only path to realize or preserve their dream.

The search for a new order was extremely painful. The wish to avoid a system of too rigidly fixed exchange rates, which had constituted one of the problems of the 1960s and which had helped to propagate inflation internationally, now produced a system whose flexibility verged on anarchy. In the event, the new system removed limitations on national monetary policy and consequently fanned inflation even further. Thus inflation now came to be seen as a product of an international system of flexible exchange rates, as well as a result of the fixed par values of the classic Bretton Woods system. In other words, inflation appeared as a problem of monetary discipline that might result regardless of the exchange rate regime. At the same time, the differing extent of countries' willingness to tolerate high levels of inflation produced a sharp divergence in national policy approaches, caused further problems in financing and provoked doubts about whether the private sector could handle the flows. The coordination problems produced by the pursuit of very different national strategies strained the international order yet further.

The collapse of the Bretton Woods currency rule led to increased temptations to apply protectionism (some writers began to refer to the phenomenon as the “new protectionism”). After the collapse of par values the world experienced a series of apparently incessant shocks and crises: the dollar shock, then the oil shock, then the inflation shock, then another oil shock, then debt. In the 1980s and 1990s, the dramatic shifts and reversals of economic expectations caused by political events continued with the shocks of the invasion of Kuwait, of German unification and of the collapse of the Soviet Union. World trade continued to grow, in fact, in the 1970s and 1980s, although at slower rates. That growth provided a testimony to the vitality of the system and to the way previous successes had produced a demonstration effect of the virtues of liberalized trade.

In the absence of the “hard law” provided by the rule-based order of the classic Bretton Woods regime, and in the presence of greater possibilities offered by the availability of capital imports, the need for effective surveillance became much greater. This requirement for a working international system was accepted in the new Article IV of the Second Amendment (1978) of the IMF’s Articles of Agreement, which stated the principle of the Fund’s “firm surveillance” over members’ exchange rate policies and also specified (Section 1) that: “each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates.”

Some of the search for effective means of channeling international cooperation, however, took place outside the context of the universal institutions created in Bretton Woods. Since 1945, a large number of institutional mechanisms had been evolved for reconciling the desire for an international economic order with the domestic concerns and priorities of nation-states. Not all of them saw the problems in terms of the requirements of a global system. The most general channels of cooperation were the Bretton Woods institutions, the IMF and the IBRD, but they played only a subordinate role in the first postwar decade. As a result, more specific institutions were required to deal with the immediate postwar problems. The GATT was the replacement for the still-born International Trade Organization (ITO) and would manage trade liberalization by negotiating abolitions of trade quotas and tariff reductions. (It would take almost fifty years for the GATT to be transformed into the World Trade Organization, launched on 1 January 1995.) The OEEC would coordinate the process of European economic integration. These institutions proved remarkably successful and lived on in much modified circumstances. The

GATT remained as a crucial forum for trade negotiations, even though the 1970s gave rise to a "new protectionism," in which devices such as Voluntary Export Restraints were created with the specific intent of circumventing GATT rules. (In addition, large parts of the world's trade—agriculture from the beginning, textiles after the 1960s, the trade in services and intellectual property—escaped the rule of the GATT.) The OEEC continued as the OECD, with general policy coordination tasks for the industrialized world. Other groupings also worked hard at the same task: the Group of Ten (G10) and then, later, the Group of Five (G5) Finance Ministers (later G7), the G7 summit process. The G10 arose out of the need to supply additional resources, in the absence of a large IMF quota increase, and then evolved institutionally as a forum for more general discussion.

With the advent of the G10, a division of the world institutionally into blocs of "powerful economies" and "developing countries" began. Developing countries produced their own institutional answers to the coordination attempts of the developed world: the UNCTAD, the G77 within the UN framework, or the G24 within the IMF and World Bank setting as a response to the power and influence of the industrialized G10. The Committee of Twenty and its successor, the Interim Committee, remained attached to the ideal of global discussion of common economic problems. At a regional level, the proliferation was even more striking: regional free trade associations and multilateral development banks.

The later coordination institutions that followed the Bretton Woods twins arose out of quite particular circumstances: the OEEC to cope with postwar reconstruction, the G10 to agree to the provision of additional lending for the IMF, the G5 out of a successful informal disucssion group, the summit as a result of the application of the G5 principles at the head of state level. A new G24, composed initially of OECD countries, was created in 1989 as an ad hoc group for the coordination of economic assistance to central Europe. The successful institutions outlived the circumstances of their birth and developed more general functions. (Perhaps the most striking example of adaptation is the Bank for International Settlements, which was originally conceived as a depoliticized way of making German reparation transfers after the First World War but which rapidly became a crucial instrument for central bank cooperation and coordination.) The outcome was a broad spectrum of institutions with rather different origins and histories but common and even competing concerns.[1] Helmut Schmidt, who was himself responsible for a part of this, institutional proliferation, explained that there existed no single world organization that could control a world economic crisis. Instead, a "wild growth" of institutions discussed and reflected on economic issues.[2] In this dense network, regular meetings between the leading national policymakers and officials became a routine, and such close contacts undoubtedly fostered international cooperation. They also sometimes, however, provoked suspicions and misunderstandings.

THE PROBLEMS

Two problems have dogged this multifold institutionalized cooperation. First, since changes and news of impending alterations offer the controllers of private funds the possibility of making dramatic gains, many marketsensitive policy issues became very hard to discuss and analyze. The more substantial the capital flows, the greater the extent of sensitivity and vulnerability. This was especially true of exchange rates and of central bank intervention on exchange markets—both in the fixed and in the flexible systems—but it is also true of interest rate policy. Second, strong political pressures and incentives led to an attempt to orchestrate policies in a narrower setting, to create "our small group."

Considering the first problem, the most remarkable postwar example of the increased difficulty of practical surveillance is perhaps to be found in the contrast between the alacrity with which parity alterations were discussed by the IMF as a tool of policy and a facilitator of adjustment in the late 1940s and the reluctance of the G10, OECD and the IMF to consider parity alterations for the major currencies in the 1960s. The extreme receptivity of markets to rumor, combined with the political delicacy inevitably associated with issues affecting national prestige, produced what amounted to a tabu on discussion. There was a fear, which grew with the threats to the credibility of the system, that any dent would make impossible the attaining of any new stability. In particular the US unwillingness after the late 1950s to consider a change in the dollar parity of gold, despite balance of payments deficits, produced near paralysis. It led to an institutional incapacity to deal with the needs of the global economic situation. In these circumstances, the only hope for change lay not in additional discussion but in deliberately obstinate or destructive behavior. The china shop needed a bull, and in the circumstances of 1971 John Connally played that part with considerable verve. One of the major tasks of a reformed system, the IMF's Executive Board concluded, would be to establish "criteria and procedures for orderly change which will accord to the United States, as well as to other members, a due measure of initiative in the effective exercise of exchange rate flexibility."[3] This story, from the classical Bretton Woods era, of increasing inability to discuss marketsensitive problems was repeated (with different institutional actors) in the story of the European Monetary System.[4] In the early years after the creation of the system in 1979, there were few problems in both discussing and undertaking parity alterations. Later, from the mid-1980s, consideration of parities within the EMS became so politically sensitive, within the European Community but also consequentially within the OECD and IMF contexts, that it was, in practice, ruled out.

This dilemma provides an example of a more general problem, that an institution responsible to member governments finds the discussion of market-sensitive material very hard, as governments may resent the implications of second-guessing the market and can only be persuaded by arguments about what the market is likely to do after the market has actually done it. For instance, in a different context, it is possible to imagine the outrage if any international institution had given a clear and statistic-laden warning about the extent of bank exposure to middle-income debtors in the summer of 1982 and thereby touched off a panic flight of funds: it needed to wait for the crisis to be triggered by market sentiment.

The second problem that has persistently affected the world economy is that of a too narrow or too partial framework for cooperation. Particularly when global cooperation failed or faltered, states looked to a more limited setting, generated by geographic proximity or by common security concerns. The initiatives at European monetary integration in the late 1960s, and again one decade later, began primarily as responses to the problems of the US dollar. Regional or selective forums for cooperation might on occasion have offered an easier way to obtain agreement, but they inevitably found it hard to discuss structural problems affecting the whole of the world economy. They did not necessarily provide a stepping stone for increased global cooperation; sometimes they constituted a diversion.

This lesson appeared repeatedly as part of the story of European monetary integration. Some Europeans saw the creation of a European zone of monetary stability as a way to greater world stability, a bold European initiative that took the place of failed global effort at stabilization: first there would be an EMS, then negotiations to make the US de facto a member of the system. This strategy did not work. The difficulty inevitably inherent in partial solutions was also evident in the important and occasionally successful role played by the G5/G7 in fostering world economic cooperation. Not all the world's balance of payments problems were between the G7 and, as a result, G7 negotiations could hardly be expected to produce a solution. Some participants responded to the problem by demanding a return to a smaller framework, a G5 or even a G3.

The G7 summit exercise had begun as a response to the enormous challenge posed by the great economic dislocations of the early 1970s. It had survived in large part because of the mixture of economic and security calculations characteristic of the later stages of the Cold War. During the 1970s, the major economic problems that followed from the oil embargo and the price increases and then from the recycling of petrodollars had been treated, especially in the United States, as primarily a security threat. In the 1980s, major economic issues, such as the construction of a Soviet gas pipeline by West European firms, were again thought of in Washington primarily as the instruments through which superpower rivalry might be conducted. Then, at the end of the Cold War, security problems raised this time by the collapse of the Soviet empire provided the major theme for summit discussions.

After the end of the Cold War, however, some commentators began to ask more fundamental questions. Who are the seven of the G7? They are certainly not, as they are most frequently described in newspapers and by many politicians, the world's seven largest economies. The seven largest in 1993 as measured by GDP, calculated on the basis of purchasing power parity, are: the United States, China, Japan, Germany, India, France and Italy.[5] Neither are they the seven most "advanced" economies, if this term is measured in per capita income (for 1990 the seven richest would have been: Switzerland, Japan, Norway, Finland, Sweden, the United States and Denmark).[6] Other criteria which might have been used are equally inapplicable. They are not the seven countries in which the world's most important financial centers are located. The seven largest stock exchanges, measured by volume of transactions, in 1992 were: the United States, Germany, Japan, United Kingdom, Taiwan, France and South Korea.[7] The closest fit of the G7 is with the list of the seven leading exporters: in 1991, the United States, Germany, Japan, France, the United Kingdom, Italy and the Netherlands (in 1975 the list was similar, with only the order of the Netherlands and Italy reversed). Fundamentally, however, the G7 are a seven composed of some powerful economies, which developed, as a matter of historical chance, into a very powerful institutional grouping. There have been attempts to enlarge the grouping. In the later 1970s, the oil producers, as they became a major power in the world economy, asked for representation at world economic summits. In the early 1980s, Mrs Indira Gandhi pressed for the participation of some of the large developing countries. In the early 1990s, some of the G7 felt embarrassed by the presence but not membership of Soviet or Russian leaders and argued that Russia should be admitted to the club. It was in 1994, at least in relation to the discussion of political issues. There was also some recognition that speaking about economic problems and attempting to produce solutions just within the G7 was inadequate. Before the 1992 summit, the US Treasury Secretary held separate talks with Latin American Finance Ministers.[8] In 1993, the Indonesian President visited Tokyo before the summit in order to explain the position of non-aligned countries. But, in general, most of the G7 felt that any enlargement would open a Pandora's box and would destroy the effectiveness of the process.

The debates about enlargement reflect the highly problematic legacy, characteristic of the 1970s and 1980s, of a mixing of security and economic concerns. As the US position relative to other non-communist industrial countries weakened in the course of those decades, it needed to find new ways of implementing its power political concerns. In reordering the institutional management of the world economy after the end of the Cold War, it would be both inappropriate and damaging if the mixing of security and economic concerns so characteristic of the previous forty years were to be continued. This linkage greatly complicated the task of international policy coordination at the highest political levels, and it continues to present problems. For example, admitting a few more countries to the G7 process simply because they are potentially worrying security threats, or because they possess nuclear weapons, is not a rational way of handling the problem of global economic coordination. Such a partial extension would leave out too many important interests and actors in the global economy: the overwhelming majority of developing countries, the Newly Industrializing Economies, and so forth. It is worth recalling that the first attempt to achieve international cooperation in trade as well as in diplomatic affairs, the Amphictyoni Councils held at Delphi, is generally thought to have failed because the councils "were never universal and many important states remained outside."[9]

Many new areas have emerged recently in which there is a risk of a confusion of security policy and economic policy, of mixing high politics with the more mundane business of commerce and finance. Making assistance or support dependent on a complex political conditionally (on human rights, for instance, or on military spending) will only politicize the operation of the international economic order. It is true that many countries, including some developing countries, reduce their economic potential by excessive military spending;[10] but there are also many wholly legitimate security concerns, and it is equally clear that without adequate protection against external attack, economic development, too, is threatened. The best way to obtain the economic benefits associated with a reduction in military expenditure is by persuasion, rather than by an extension of conditionality. It is also true that a good deal of evidence shows that democratic societies in which human rights are respected, and which enjoy a higher measure of social stability, perform better economically on the whole than controlled societies.[11] But processes such as democratization do not lend themselves to the formulation of simple measures or rules of the kind provided, for instance, by balance of payments statistics. These kinds of interventions are almost bound to provoke the response that they favor the power interests of a particular group of states.

Two highly controversial issues of 1994–5—the restructuring of economies in Russia and other former Soviet Republics, and the Mexican peso rescue—have suffered from over-politicization because of the extent to which they were conducted outside the framework of a clearly understood body of rules and outside the institutional setting of the IMF. The virtue of the Bretton Woods mechanism was that it created a depoliticized way of dealing with economic issues.

THE CHANCES

An increasingly prevalent view holds that the market alone should do the job of providing information: that the institutional framework of Bretton Woods was highly effective in restoring the world to the near complete capital mobility that prevailed in the golden years before 1914, but that the fundamental task of rebuilding a liberal, globalized economy has been accomplished. (There may still be some way to go, but a large part of the journey is done.) Many responsibilities are currently being transferred to the private sector, where they are often better handled than they are by public authorities. In practice, however, governments continue to wish to direct and regulate capital movements in more or less concealed ways—through fiscal measures, regulatory directions, jawboning about the appropriate level of exchange rates. Markets tend to remain liable to faddishness or herd instincts. In consequence, there is still a need for an institution to examine and compare national policies which affect the movement of capital internationally. If, in the years after Bretton Woods, the emphasis was primarily on the liberalization of the current account, the period after the breakdown of the par-value system saw first increasing debate about the desirability of liberalizing capital flows, and then a need for the effective management of that liberalization. The need arose for international judgments about the use or abuse of capital market liberalization for purposes that might be beneficial to individual participants but could also be collectively harmful.

In this regard, the two problems outlined above appear particularly acute: the difficulty posed to policy discussions by the sensitivity of markets and the volatility of international capital; and the proclivity to look to partial or regional answers to the demand for enhanced cooperation. What answers can be found to these long-standing dilemmas? The first issue—the tabu on discussion of some policy issues—can be at least in part solved by the creation of a common context (of fiscal consolidation and a stabilityoriented monetary policy), in which the expectations of the market are stabilized (and markets are, as a result, less sensitive). If policy is conducted in a longer time horizon there are fewer abrupt changes to which markets will react violently or attempt to anticipate. The IMF has consistently insisted on structural reforms and structural adjustments in order to create a stable framework of expectations: including the opening of markets, more flexible domestic products and labor markets, an opening to capital movements, as well as fiscal and monetary behavior conducted in terms of a stable medium-term strategy. The best means of lengthening the time horizon is to mount the cooperation process in as broad a context as possible (thus providing the answer to the second problem, of partial cooperation). It was an essential part of the vision of Bretton Woods that the institutions created to supervise and channel economic cooperation should be universal. With the end of the

Cold War, that promise of universality has at least been virtually fulfilled. The membership of the IMF is now nearly identical with that of the United Nations; and the GATT has also gained members.

Designing a universal financial institution, however, is not as simple a task as it may at first sight appear. As a financial institution, the conduct of the IMF is determined by a set of rules and procedures which distinguish it from other universal institutions, notably the United Nations. The principle of weighted voting, approximately in line with the quotas of members, has always been an essential feature of the Fund's operations. Voting is not important, in practice, in the overwhelming majority of decisions made by the Executive Board, which tends to operate rather through the process of discussion and the emergence of consensus. But it is critical in making basic policy decisions, such as the creation of new facilities or the issue of SDRs. Weighted voting was much criticized, especially in the 1970s, when a highly politicized debate over the shape of international institutions flared up. The advocates of change believed that a one-member one-vote principle or a transfer of responsibilities to the United Nations General Assembly, or some other body operating a similar voting rule, would be more democratic and would produce, in particular, an international financial order more responsive to the concerns and needs of developing countries. The defenders of the existing system pointed out that weighted voting was more appropriate to a financial institution, since votes would result in commitments and obligations that were proportionate to quota size.

These discussions were only an extreme example of the difficulties surrounding any quota-based approach, in which there is necessarily an element of arbitrariness. The basis of the allocation of quotas in the Fund has always been controversial. Even at Bretton Woods it was the basis of painful tussles between the conference participants. The original formula, devised already in 1943 in the United States, was based on historic figures on national income, foreign reserves and international trade (in terms both of value and of the variations of exports). In the Quota Review of 1959, additional consideration was given to the growth of trade; in 1964, a larger range of formulas was used to calculate a quota range. The 1975 Quota Review began to treat economies for the purpose of quota determination in groups (industrial; more developed primary producers; oil exporters; developing countries). As a result, the quotas calculated under variants of the "Bretton Woods formula" began to diverge from actual quotas. The largest quota holder has always been the United States, but in each successive general review the US share has been reduced. So, too, has that of the United Kingdom, which originally had by far the second largest quota. At the same time, since 1959 the quotas for Germany and Japan have been increased; so were, in the 1975 and 1978 reviews, the quotas of the large oil-producers. The quota calculations obviously reflected shifts in the structure of the world

Table 2.1 Membership of UN, IMF and GATT, 1945–93

Year	*IMF membership*	*UN membership*	*GATT membership*
1945	30	51	——
1946	40	55	——
1947	45	57	——
1948	47	58	18
1949	48	59	19
1950	49	60	28
1951	50	60	32
1952	54	60	32
1953	55	60	33
1954	56	60	33
1955	58	75	34
1956	60	79	34
1957	64	81	36
1958	68	82	36
1959	68	82	36
1960	68	99	37
1961	74	104	39
1962	81	110	43
1963	101	113	59
1964	101	115	63
1965	102	117	65
1966	104	121	69
1967	107	122	74
1968	111	123	75
1969	115	123	75
1970	117	126	77
1971	120	131	79
1972	125	131	80
1973	126	133	82
1974	126	136	82
1975	128	142	82
1976	129	145	82
1977	132	147	82
1978	138	149	83
1979	140	150	84
1980	141	152	84
1981	143	155	85
1982	146	155	87
1983	146	156	89
1984	148	157	89
1985	149	157	89
1986	151	157	91
1987	151	157	94
1988	151	157	95
1989	152	157	95
1990	156	158	99
1991	158	165	102

Table 2.1 continued

Year	*IMF membership*	*UN membership*	*GATT membership*
1992	175	179	104
1993	178	184	114
1994	179	185	128

Note:
Fund membership at end of December 1994:179
UN membership at end of December 1994:185
GATT membership at end of December 1994:128

Adjustments were made to UN tables to reflect the following shifts in membership:

1 Tanganyika, a member of the UN from December 1961, and Zanzibar, a member from December 1963, continued as one single member in April 1964, changing their name to United Republic of Tanzania in November 1964.
2 The Yemen Arab Republic (admitted to the UN in 1947) and the People's Democratic Republic of Yemen (admitted in 1967) were amalgamated as one nation, the Republic of Yemen, in 1990.

Adjustments made to Fund tables according to footnotes in Membership list.

UN and GATT information provided by these organizations.

economy, but it is not clear that the current quota distribution accurately represents the pattern of economic power.

The Japanese and German quotas, in particular, are significantly lower than either their share in world trade or their share in international currency transactions. As the issue of a changed or enlarged membership of the Security Council is debated, it is likely that increased representation in the IMF of the second and third largest economies of the world will also become a topic of concern. In the past, in the later 1970s, one of the reasons that these quotas were held down involved an explicit penalization for what were felt to be inadequate efforts in the surplus countries to bring about greater global growth[12]. The same reasons might be given for an opposite response, an attempt to bind surplus countries and issuers of "key currencies" more tightly into the framework of responsibility for world economic decision-making.

THE CONSENSUS

Intellectual developments have created a new potential for effectiveness of global institutions. One of the most startling developments of the 1980s and 1990s has been the emergence of a consensus about many economic issues. A great part of the difficulties faced by the makers of Bretton Woods was due to their inability at that time to build on such a consensus. At the outset of the postwar era, no consensus existed on how to deal with the problems of domestic economic management or on how the domestic economy would affect the international order. As a consequence, for most of the postwar period, institutional arrangements were generally strained by the absence of a common agreement or outlook. They were torn by disputes about the advantages of protection, or disrupted by disagreements about the effects of fiscal deficits, or paralyzed by differences about exchange rate policy. Some countries, notably France, had committed themselves to a mixed economy with a sophisticated system of indicative planning and investment allocation. Some, like the United Kingdom, relied on finely tuned macroeconomic management. Others, in particular Japan, eschewed formal planning but created an extensive system of informal coordination and administrative guidance. Germany, Italy and the United States followed a much less interventionist course. In many newly independent countries, Soviet-type central planning appeared as a promising way to rapid growth. The IMF's Articles of Agreement very deliberately protected national sovereignty and allowed states to formulate for themselves their own economic and political interests.

At the outset of the postwar economic miracle, many observers deduced that classical or neo-classical economic theory was bankrupt when it came to dealing with the "real world" of politically motivated behavior. Jacob Viner, for instance, in 1951 wrote that: "The world has changed greatly, and is now a world of planned economies, of state trading, of substantially arbitrary and inflexible national price structures, and of managed instability in exchange rates. The classical theory is no longer directly relevant for such a world, and it may be for such a world there is and can be no relevant *general* theory."[13]

The absence of a shared framework for analysis repeatedly proved frustrating. For a time, the Bretton Woods system itself guaranteed a consensus about the *international* order and the desirability of an *international* rule, simply because it coincided with, and also helped to produce, spectacular economic growth and widespread prosperity. Gradually, however, *national* concerns overwhelmed the commitment to the international order. In the 1970s, major international imbalances resulted from differences of view about the appropriate speed of adjustment to the consequences of the oil price shock. When some states adjusted earlier than others the national differences were often fought out as rival interpretations of what the world economy needed. The quick adjusters (Germany and Japan) thought that the other states were causing international inflation; the latecomers (particularly Italy and the United Kingdom, but on some occasions also the United States) thought that the rapid adjusters were constraining world growth.

The proposition that inflation or permissive monetary and fiscal policies could not represent an adequate way of sustaining high rates of growth was accepted more quickly in the context of national discussions of macroeconomic policy; it was only at the end of the 1970s that it became a widely shared international viewpoint (and then became a common feature of G7 summit and Interim Committee communiqués). The new insight came in large part because of the economic instability created by the sharp expansion of world money during the 1970s. The IMF played an important part in the discussion of the new problems by consistently arguing that, in the case of surplus countries, the need was less for greater fiscal or monetary stimulus than for more far-ranging "structural" measures, including trade opening, greater flexibility in labor markets and (especially in the 1980s) a greater emphasis on marketization, competition and privatization.

As late as the first half of the 1980s, major differences in analysis between countries still remained. Leading US policy-makers refused to accept the elementary economic proposition that current account imbalances are identical to the national balance between savings and investment, and that, as a result, fiscal policy could be responsible for a fall in saving which would need to be financed through foreign savings. The resulting inflows would explain the rise of the dollar on the foreign exchange markets. These debates were wider in their implication than merely informing Americans why their dollar was like a yo-yo on foreign exchange markets. The discussion raised the issue that had been central to the overall success of the world economy since Bretton Woods.

The initiative for the opening of the world economy after 1945 came largely from one country, the United States, sometimes indirectly, through its great influence over international institutions (which was especially strong, and beneficial, in the immediate postwar period), and sometimes directly, through its trade policy. When, after the end of the dollar shortage, the United States became worried about the emergence of new surplus countries (first Germany, then Japan and later the East Asian "tiger" economies), the character of its response inevitably affected the development of international institutions and also of the world economy. The political argument swung backwards and forwards: demands for trade restrictions and bilateral trade-restricting agreements appeared, the exchange rate policies of the surplus countries were questioned, and the United States wanted to use bilateral (and sometimes also institutional) presssure to force an appreciation of the surplus currencies. If the forces pushing in the other direction rely simply on an appeal to beneficence they can scarcely hope to succeed; many will ask why Americans should make sacrifices to support the world economy. Understanding how measures that lead to a reduction in global trade will hurt national welfare is a hard task, particularly because it runs counter to deeply held beliefs that governments should be activist, should "do something," in the face of an economic difficulty. The temptations to break with the liberal concept of the global economy can be overcome only through an effort at understanding. When surpluses and deficits are understood less in terms of trade performance than as a reflection of different levels of saving and investment there is a possibility of moving to a debate on how the behavioral patterns associated with saving and investment can be modified. This is a much broader social process than altering tariff schedules, negotiating deals with manufacturers of particular products, or even changing government fiscal policy. It is harder for governments to address directly.

Over the past two decades, as a result of unsatisfactory economic experiences, opinions about appropriate and inappropriate diagnoses and policies have changed. Something approaching a diagnostic and policy consensus has emerged in both industrialized and developing countries. Here are the commandments of the modern decalogue:

1 The most fundamental lesson is that long periods of the application of an inwardly oriented import substitution industrialization are harmful, even in countries, such as Brazil or India, with very large domestic markets. A separation from the world market produces an inappropriate price structure, which generates misleading signals for the allocation of resources and, as a result, misinvestment. Governments are sometimes tempted and sometimes forced to manipulate the internal price structure to the advantage of influential groups. The result is an overall economic loss. The world market does not provide simply "competition" which might stimulate innovation and development; it also provides the only reliable and effective guide to the appropriate distribution of scarce resources (and a much better one than could be given by any government planner). In addition, the turning of the internal terms of trade to the disadvantage of agriculture contributes to the growth of rural poverty and to the generation of extreme disparities of income and wealth. The consequences are socially and politically destabilizing.

2 Links with the capital market affect the course of development. Industrialization or development that proceeds through a series of abrupt stops and starts as a result of changing conditions on international capital markets can carry harmful economic and political consequences. But capital movements are an essential part of the development process. There is a need to ensure that there are no substantial misallocations which might produce an abrupt reversal of confidence and a capital outflow. Again, the economically optimal outcome is best produced by letting a price system respond to market conditions. A code for capital liberalization might be a desirable successor to the existing IMF code, which requires a movement to current account convertibility (under Article VIII of the Articles).[14]

3 There are times when it appears that the markets do not necessarily always "know best" (though governments acting on their own usually "know even less"). Major failures of coordination between countries can produce dramatic shifts in the pattern of capital movement. Steady and coordinated policies are required for capital allocation to be made in accordance with the appropriate judgment by the market of long-

term development potential. States have to help the markets know best by pursuing consistent policies, through time as well as among countries.

4 The public sector is a major player in capital markets. It appears to offer potential investors the greatest security. But in an uncertain world such security has its disadvantages. State borrowing may be less appropriate as a means of facilitating market judgments than borrowing and investing through corporations and individuals. There are, then, a much larger number of judgments being made about the economic future, and there is scope for some to be right (succeed) and for others to fail. States may feel the temptation to steer against the judgment of the markets and then, if such steering does not prove effective, to impose capital controls. These controls are rarely watertight and have not, on the whole, been effective instruments in stopping or reversing capital flight.

5 In addition, large fiscal imbalances can be very destabilizing and contribute to a mismatch of national savings and investment. Balance of payments problems are often a consequence of excessive monetary creation for the purpose of financing fiscal deficits. But fiscal problems are often highly intractable, and can only be dealt with effectively within a wider framework of general structural reform.

6 Over-valued exchange rates, which are often presented as an effective way of subsidizing basic or necessary imports, or as an effective way of fighting inflation, and which are frequently supported by powerful and influential lobbies and interest groups, represent the equivalent of a tax on exports and frequently harm long-term development prospects.

7 Flexible exchange rates are not undesirable, and indeed often represent an ideal way of accommodating external shocks. On the other hand, highly volatile exchange rates, which are often the result of the pursuit of inconsistent policies, have a damaging effect on economic performance and are likely to intensify calls for the adoption of protectionism.

8 Monetary policy is best set by authorities which are as independent as possible of both the government (and associated political pressures) and the financial and banking sector (and associated day-to-day market pressures). It may be desirable to anchor the autonomy of the central bank through legal provisions.

9 The process of economic growth everywhere—including in developing countries—can be profoundly affected by an inappropriate policy mix in the major industrial economies.

10 There is no separate economic truth that applies to developed, or to developing, countries.

The one area—and it is an extremely important one—where no substantial agreement has emerged yet is over international monetary and exchange rate policy. In particular, the debate conducted since the 1950s in an academic milieu and since the early 1970s in policy circles between fixed and flexible exchange rates remains unresolved. Some commentators believe that the accelerated pace of internationalization makes the transactions costs imposed by the multiplicity of currencies an increasingly significant deterrent to economic activity.[15] Others continue to argue that exchange rates are "just another price" and that, like other prices, they should be allowed to fluctuate freely and give necessary signals for participants in a market. Like the academics, policy-makers and political and business elites are divided. Businessmen frequently complain about the uncertainties caused by exchange rate changes. Many policy-makers have often staked their reputations on exchange rate stability: devaluations are viewed as a national humiliation; effective revaluations (in the surplus countries, which are highly export dependent) as a blow to the interests of exporters. On the other hand, if domestic costs and wages lead to an uncorrected movement of the real exchange rate the result will also be the imposition of a distinct economic cost; and adjusting the exchange rate will often be the only politically feasible way of avoiding an under-utilization of resources, idle plants and an unemployed labor force.

Adjustments in exchange rates provide a way of compensating for sudden changes in supply conditions and perhaps also of compensating for mistakes or misjudgments in the policies of national governments. There is, in fact, general agreement that the avoidance of policy mismatches would lead to greater exchange rate stability (while the stabilization potential of exchange rate intervention is far lower); and also general agreement that this outcome would be desirable. In this way, greater exchange rate stability might be expected to be the outcome of other areas of policy consensus: it is more likely to be achieved in this way than as a consequence of the creation of pre-set commitments by policymakers, which would only represent an open invitation to the testing and second-guessing through market sentiment. The increased extent of this guessing about the likely consequences of policy might in itself make the markets more disorderly and produce increasingly volatile exchange rate behavior not linked in any way to underlying "fundamentals."[16] Exchange rate stability could, in short, be seen as a desirable outcome of policy but not as a very useful policy instrument.

The aspects of the "new consensus" listed above are the product of a number of circumstances, which have culminated in the evolution of an intellectual conversion. It was not, however, an outcome of any great idealism about international cooperation. One of the enchanting peculiarities of the intellectually divided climate of Bretton Woods was its remarkable and persuasive vision of international harmony despite all the differences in national approaches. That degree of goodwill was needed, at that stage, precisely because of the absence of agreement. As the initial enthusiasm waned, as it was bound to do, other considerations became important. First of all, the lessons about openness were drawn initially by some development economists and then accepted more generally. An intellectual consensus, however, is not enough by itself to produce a policy effect. Academic economists, for instance, have consistently pointed out the economic losses inherent in trade protectionism, and for much of the last two centuries there has been something approaching a theoretical unanimity on this issue. That fact did not stop governments in the late nineteenth century, or more disastrously in the 1920s and 1930s, or again after the 1970s, from taking up protectionist measures.

Second, the world was battered into the new consensus by the repeated shocks experienced over the past two and a half decades. Indeed, perhaps paradoxically, it was those societies that were most exposed to the external shocks and that did not attempt to cushion themselves through accommodating monetary or fiscal steps that learnt most quickly the lessons about the gains to be derived from openness. This was one of the features of the successes of the East Asian experience, where economies dependent almost entirely on imported energy found themselves very vulnerable in the 1970s. On the other hand, societies that attempted to isolate themselves often found that they were hit by a shock which was magnified as a consequence of delay.

Third, countries learnt from the experience of others. Often the experience of a particular national crisis was required to drive home the lessons already learnt in other contexts: in Germany after 1945, in Spain in 1959, in Korea in 1960, in the United Kingdom in 1976, in France in 1983, in the United States in 1985, in Mexico in 1982 and 1985, in India in 1990 and 1991, or in the almost permanent crisis of Soviet-style economies in the 1980s. Some commentators have come to the conclusion that we need to experience a crisis in order to adjust our views. The modern economy, according to one dramatic analogy, is a giant plodding forwards while always looking backwards. It is only when the giant trips that he gets a glimpse of the future as he stumbles.[17] Do we always need to face near catastrophe in order to adjust ideas and policies?

An easier way of coming to terms with changes is to learn from the experience of others. We might try to equip the backward-looking giant with a system of lenses and mirrors, so that he knows what other giants are doing and can see a better way forward. Providing these reflective glasses is part of the surveillance function. One of the most important developments of the postwar era, and one which became more intensive during the course of the 1980s, has been the internationalization of the learning process. Ideas and knowledge have become an international commodity. The success of export-oriented industrialization in Asia demonstrated to Latin American economists and policy-makers the drawbacks of import substitution strategies. East European states in 1989 learnt from the successes of German adjustment programs in 1948, of the East Asian NICs in dealing with the oil crises, and of the adjustment of Chile or Mexico after the debt crisis. The experience of the first reformers in Poland, the Czech Republic and Hungary in turn may serve as a pattern for later reform initiatives in formerly centrally planned economies.

In many cases, the transmission of this learning has been through highlevel technocrats, who have often either been educated or worked abroad: for example, the "Ford Foundation gang" who stabilized Indonesia in the later 1960s, or the Chilean "Chicago boys" from the exchange program of the Cathodic University of Santiago or individuals in Central Europe in the 1970s and 1980s who went to North American universities (such as the Czech Vaclav Klaus).[18] Working in international institutions, especially in the World Bank and the IMF, has been an additional way of consolidating and sustaining this "technocrat learning" and creating an international community of ideas between central bank and finance ministry officials.

The converse of the experience of learning from other countries' experiments is that those states which insist most vigorously that their problems and positions are quite unique and incapable of comparison find themselves sooner or later in trouble. This is true of cases as diverse as the United States in the early 1980s, which believed that it had found in tax cuts a unique key to growth, or Brazil's insistence in the 1960s and 1970s on the virtue of import substitution as a strategy for countries with exceptionally large domestic markets. In medical experience, the realization that one's problems are not singular is an important step on the road to health: the principle holds true for economies as well.

One of the major contributions of surveillance to the development of the international economy has been an institutionalized mechanism for sharing and learning. The fact that the move to consensus was so often accompanied by shocks indicates that its continuation may depend not only on a general preaching of "sound economics" but also on specific help in micropolicy advice and the design of economic institutions (central banks, fiscal systems), as well as in the provision of resources in dealing with the aftermath of shock. Surveillance allows the dissemination of economic information, including advice on successful strategies (as well as examples to be avoided of unsuccessful strategies). It also provides a mechanism through which states can influence the other actors in the system: through the transfer of information and through discussions in the context of multilateral surveillance. In the past, a major channel for the supply of this information was through governments and through technocratic discussions among high-level officials. This will undoubtedly continue to be the case to a considerable extent in the future. The opening of many societies, and the increased importance of public discussion, also requires an increasing openness about information and about economic prescriptions; and this new openness, too, has been one of the features of the maturing of the surveillance process.

In this way, with enhanced publicity, the IMF's "machinery for consultation and collaboration on international monetary problems" has evolved into a source of institutional and structural innovation and reinvigoration. As a result of the demand for surveillance, it has developed into a continual process. The periodic Article IV consultations are the basis of biannual *World Economic Outlook* exercises, which involve the gathering, synthesis, discussion, and reporting and transmission of information. As a result, these exercises are continually in motion; in addition, there are regular and more frequent sessions of the IMF Executive Board devoted to world market and market development.

In this long-term development, which has been occurring at least since the 1960s, the rule of Bretton Woods has been replaced by knowledge; an information standard has succeeded a gold or dollar/sterling or dollar standard; and the influence of the institution at the heart of the international financial system depends largely on its ability to provide speedy, accurate and persuasive economic analysis. This is the consequence of the development of capital markets, which make it impossible for an international financial "system" to police and control national policies—as it had done up to the 1960s. It is this development which makes it increasingly inappropriate for the Fund to be used in the manner of the 1960s and 1970s, as a scapegoat or political lightning rod for weak governments frightened about the loss of political popularity. An important part of any economic reform process lies in explaining why it is desirable and what the benefits will be; and this cannot be done simply by pointing at an outside institution. Already before the First World War, a British Prime Minister, A.J.Balfour, had argued that "democracy is government by explanation." Governments need to explain more; and so also do international institutions. The redefinition of the Fund's role reflects a general shift in the global allocation of responsibilities between the public and the private spheres, with an increasing preponderance of the latter: the general transfer of the activity of choice to the collective outcome of millions of independent decisions. But the role of international institutions will also reflect the possibility of a collective dysfunction of the private sector and the need to deal with the consequences of potential breakdowns.

The financial function of the Fund is as a supplier of liquidity to countries with inadequate access to the market because of market failures: sometimes a failure of the international market (such as in the generalized crisis of confidence brought by the international debt crisis of 1982, where the Fund had to step in to marshall the market); sometimes a weakness or inadequacy of domestic markets of the kind that characterizes many low-income countries. In the case of the latter, there is poor or no access to capital markets. In these circumstances, the Fund operates as a gateway to the international financial system. The contribution that is made by international institutions is both immediate and longer term. The surveillance exercise is intended (in these as well as in the other cases) to make markets function more effectively. In a perfectly functioning world there would be no need of the Fund as a financial institution, because the reserves of confidence built up would be sufficient to make impossible the outbreak of panics or crises. It is scarcely necessary to point out that this world does not at present exist and is not likely to be created in the immediate future. However, what already does exist is the intellectual framework (the "new consensus") with which it might be constructed; and the institutional framework through the universal Bretton Woods institutions, to supervise and advise policies in line with that consensus.

Since the (relatively recent) rise of the consensus, calls for a new Bretton Woods, or for a new redesigning of the international monetary system, have become much more narrowly focused—and not simply on grounds of practical difficulties in the way of achieving a far-reaching revision. In 1989, Robert Solomon still stated that "a desire for reform is sitting in the breasts of numerous economists and of the officials of some countries." By 1991, Otmar Issing was claiming that "a reform of the world monetary system a la Bretton Woods is neither possible nor necessary."[19] Instead of massive reform, most suggestions require instead only a modest tinkering: the issue of new SDRs for developing countries or countries in transition, or more effective ways of implementing and realizing surveillance, or the delineation of responsibilities between IMF and World Bank, or IMF and BIS, or IMF and WTO. One of the reasons for the greater degree of realism about the international system is a greater measure of success in its operation.

The increasingly widespread adoption of policies based on the consensus, especially in many developing countries since the mid-1980s, has led to results in the form of higher growth (in only one year since 1985 did growth in developing countries fall below 3.5 per cent, and developing countries as a group grew at high rates in 1992 and 1993 as they recovered from the world recession of the early 1990s). The willingness to see expanded trade as an engine for growth resulted in the successful completion of the GATT Uruguay round, with the extension of GATT principles to textiles and intellectual property, and in the agreement to establish the World Trade Organization. Largely as a result of the commitment of fastgrowing developing economies to the central liberal vision of the Bretton Woods era, the dangers of a "new protectionism" on a global scale were lessened.

At this stage, the reader may feel some hesitation. Obviously not all intellectual differences over economics are solved, nor are they likely to be. Perhaps the extent to which the new "mono-economics" has achieved a practical and intellectual ascendancy should not be over-stated. The single world economy may not be necessarily intellectually or theoretically appealing to every observer. Politicians, decision-makers, businessmen, bankers do not always feel themselves to be part of a single, universally applicable system. They are often eager to castigate the modern consensus as too short term, too chaotic, too liberal, and sometimes, also, too Anglo-Saxon. They complain that excessive Iiberalization may make impossible a steady policy approach. They claim that large capital flows may undermine exchange rate stability and may thus make it harder to formulate a longterm view and instead lead to "short-termism." They say that the costs of liberalization have been too high and have produced unacceptable shifts in income distribution, that globalization has led to the pauperization of unskilled workers in some industrial countries (notably the United States), and permanently high unemployment levels in those countries with more generous social security systems that stood in the way of wage adjustment. Or the critics demand that the state should play a larger role in development than is provided for in an approach which they castigate as "doctrinaire."[20]

Some observers occasionally present the East Asian success story as less a victory of liberal economics than an outcome of a tradition of economic planning. In particular, in countries where past attempts at planning have failed, often dramatically, institutions or individuals with a historic commitment to the planning approach have tried to draw the lesson from rapidly growing NICs that policy directives may work better than a market. Some Japanese observers have made the claim that the strength of the Japanese economy derives from a dirigiste approach which may make the Japanese experience particularly relevant to the problems of formerly centrally planned economies.[21]

In addition, the arguent may not be about simply economic efficiency. It should also be concerned with a wider arena and with more fundamental human problems. How can the demands of justice be reconciled with those of international economic stability and growth? What is the nature of the trade-off between justice and growth? No international order can survive for very long if it is widely perceived to be fundamentally unjust. Avoiding large disparities of wealth and income within national economies may be a prerequisite of social justice, but it is also clear from many examples from the world's most dynamic economies that a better distribution is often accompanied by faster growth. Within national economies, policy reforms aimed at preventing the pauperization of the unskilled may in the longer run best be directed to raising skill levels generally.

The same principles will be true internationally. A world in which a large number of very poor countries continue to be very poor is also a world which unnecessarily limits opportunities. Combating poverty is, as a consequence, an essential task of the international community if it wishes to create a stable system. It should also be a part of the program design of international institutions such as the International Monetary Fund (which has indeed paid more attention to these issues over the course of the 1980s). The current Managing Director of the IMF frequently refers to poverty reduction as an essential “fourth pillar” of any adjustment program. The crucial element in this strategy is the design of social safety nets, in order to prevent the pauperization of those displaced in the course of an economic restructuring. In the absence of such nets it is often impossible to gather sufficient support for a radical market-based economic reform. An additional political dimension may mean that the creation of an adequate support system is blocked by vested interests attempting for their own ends to stymie the process of economic reform and liberalization.

This struggle for justice needs to be conducted within the general framework of a system that offers incentives for alteration and improvement, rather than working through restraints and coercion. Attempting to deal with injustice in the past has too frequently involved the imposition by authorities of restraints which produced perverse and perhaps unintended consequences, and which led to greater injustices. Penal taxation as a way of redistributing wealth and income, or intervention in price-setting in order to determine the allocation of resources between different sectors of the economy, has too often produced a system of disincentives, which only the exceptionally ingenious or politically well-connected can work out how to avoid. Liberalizing is frequently a part of any effective campaign against poverty. On the other hand, it is not enough by itself. A participation of richer countries in the exercise of creating incentives is unavoidable. This may involve specific transfers for particular projects; or a more radical and far-ranging approach to the disincentives created by the presence of large external debt. The chances of dealing with poverty through investment in broadly-based education, in health and in infrastructure all involve creating better opportunities for larger numbers of people. Such an approach is not only compatible with increased international openness; it is an indispensable part of such an opening.

Finally, even a theoretical consensus may not have hard policy consequences. Many countries continue to say one thing while doing something completely different. Although there may be a new intellectual orthodoxy, practical interests continue to push politics in a different direction. For a variety of reasons, countries experience pressures—political, social, demographic—which make it hard for their governments to return to fiscal balance. As a consequence, many governments throughout the world engage in large-scale dissaving. Many industrial countries have accumulated large and unfunded liabilities to a future in which their populations will have aged. In addition, whatever the theoretical attractions of an open economy, there are many interest and pressure groups which push in the opposite direction. Often the losers in a move to openness have an acute sense of their losses, while the potential beneficiaries cannot clearly perceive the extent of gains that lie in the future (and whose distribution is not clear). In these circumstances, international institutions that reinforce the lessons of the international consensus can play a valuable role in countering the harmful influence of specific pressure groups. The international community and international institututions are often defenders of the "general interest" in national debates where particular interests can organize and articulate themselves powerfully but to harmful effect.

These and other partial reactions against internationalization and the emerging economic policy consensus may be inevitable. Policy-makers may talk and talk about trade openness, about the limitation of fiscal deficits and about the decontrol of prices, but often in practice they find it difficult to act on these fine principles. They will be pushed invariably by a wide variety of domestic interests which often see strong particular gains from not being open. The result of such pressure may be beneficial to the powerful and articulate but carry an overall cost for the society. One result of the consensus, however, is that it can be invoked as a justification for a policy which can deliver higher overall gains. As a result, few any longer see a fundamental opposition between the requirements of the international system and the priorities of the national economy. Even more significantly, many have begun to see the international order, and international debate, discussion and surveillance as a valuable ally against the ascendancy of particular political and economic interests.[22] In this way it provides an essential component, not just of the international financial system but also of a mechanism for the creation of wider stability and of an international society that is more just.

THE OVERLAP

The provision of global surveillance raises some questions abut the links between international organizations and about their spheres of action. There are several institutions dealing with some aspect of international economic, and particularly monetary, cooperation. The key issues in the future will be:

1 The management of global liquidity. One of the central developments of the postwar period has been the dramatic growth in private-sector markets. Liquidity is no longer expected to be supplied by international institutions. The problem of regulation has not disappeared, however; the international character of finance requires a cross-national cooperation of regulatory authorities. In the past, both the IMF and (more directly) the BIS have been concerned with such regulation. How will it be managed in the future? If, for the past twenty years, the most crucial bilateral institutional relationship of the IMF was with the World Bank across 19th Street in Washington, a major theme of the next twenty years will be contacts between Washington and Basle. As lending takes

place more and more across national frontiers, involving different national regulatory authorities and, in the case of financial crises, major international adjustment problems, an international lender of last resort has become more essential as part of the world monetary system. The debt crisis of 1982 demonstrated the way in which such a need brought the IMF and the private financial sector together.

2 Adjustment policies. The evolution of a longer time horizon, and the degree of access of industrial and even many middle-income countries to private markets, has brought the World Bank and the IMF closer together in dealing with the problems of poorer countries. Their functions remain separate, in that the IMF is primarily a monetary and not a development institution, but effective institutionalized cooperation between the two is needed if there is not to be a widespread rejection of the Bretton Woods twins on the part of their members, clients and owners.

3 Confidence. There is a need for a stable policy framework among the members of the international financial system. In the recent past, this has been the task of the G7. Reasons have been set out above for thinking that this might better be tackled by a genuinely universal institution and within the framework of the IMF.

To this classical trinity of considerations in an international financial system should be added a fourth:

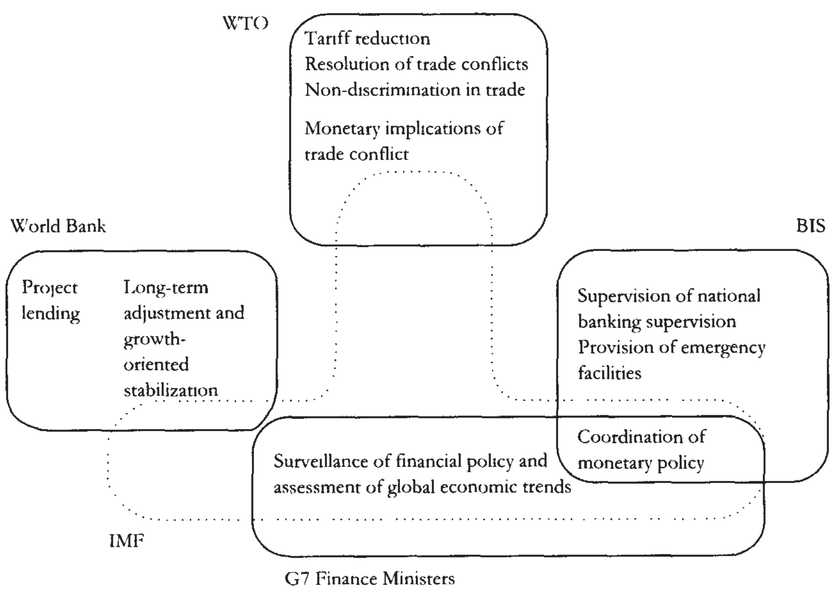

Figure 2.1 Weak IMF

4 Trade policy. One of the *raisons d'être* of the IMF was to prevent monetary policy being used as an instrument of trade wars; and the first Fund Article of Agreement refers to a duty "to facilitate the expansion and balanced growth of international trade." In the process of IMF surveillance of exchange rate policy, the liberalization of trade and the priorities set in the new World Trade Organization will be a major consideration. It has repeatedly been demonstrated that trade liberalization is one of the most important components of effective and sustained economic reform and adjustment. The agreement establishing the WTO requires it to cooperate with the IMF and the World Bank to achieve "greater coherence of global economic policy-making," but as yet the contents of such coherence have not been made clear.

The world faces an institutional choice between an order in which these aspects of surveillance are fragmented and treated in separation, with a weak IMF (Figure 2.1) or, preferably, one in which the elements of surveillance are more effectively coordinated, with a stronger IMF (Figure 2.2). The case for greater coordination between international institutions rests on the substantial extent of the linkages that exist between different global economic problems. Issues such as interest rate levels, macroeconomic orientation, debt problems and capital flows cannot be treated adequately in isolation from each other.

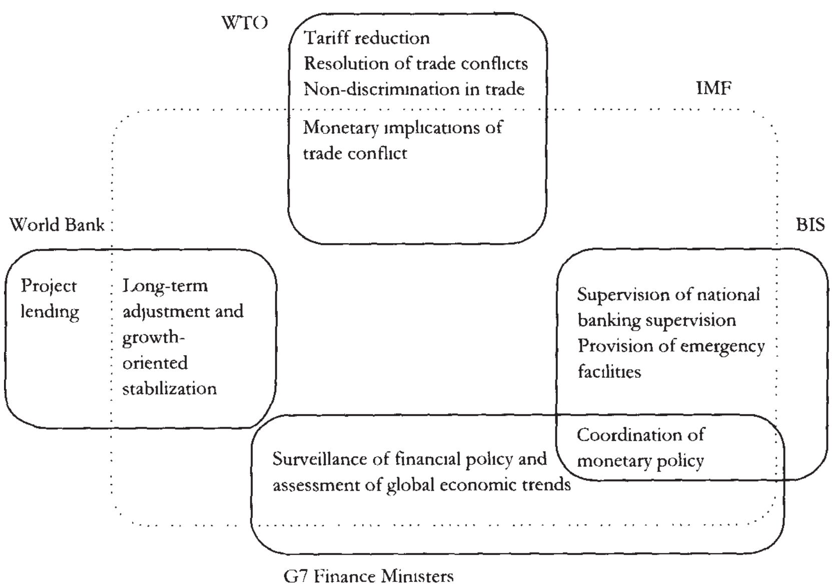

Figure 2.2 Strong IMF

CONCLUSION

A long-run historical view can help in providing a useful antidote to two common errors in policy formulation. The world and its leaders tend to lurch dangerously between two opposite poles: either an exaggerated belief in the intractability of problems, or an over-confidence as to their solubility. At some times, almost all the experts, politicians and the media agreed that the horizon was clear, with no problems or dangers in sight. At other points they also held a consensus view, that the difficulties were too overwhelming, the sacrifices required too great to be bearable, the world's available statesmanship too puny to deal with the task in hand. These over-extreme answers to the question of whether and how the problems of the international system might be solved have been formulated regularly, with regard to a whole range of issues. Hubris and despair chase each other in quick succession, as contemporary opinion swings between optimism and dark despair. Whether the question at stake was recovery from the inter-war Great Depression, the reconstruction of Europe and East Asia after the War, the monetary inflation of the later 1960s, the oil price shocks of the 1970s, the debt crisis of the 1980s, the structural problems of sub-Saharan Africa, or the transition from centrally planned economies, all provoked extremes, sometimes of confidence and sometimes of self-doubt. The task of international institutions, and of the surveillance process, is to ensure that both are avoided and that problems are analyzed, understood and then tackled.

NOTES

* This essay reflects the conclusions of a history of the international monetary system prepared by the author for the International Monetary Fund. The opinions expressed are personal and do not represent the views of the International Monetary Fund.

1 Dam, K. (1982) *The Rules of the Game: Reform and Evolution in the International Monetary System,* Chicago: University of Chicago Press, p. 169.

2 Gold, J. (1979) *Legal and Institutional Aspects of the International Monetary System: Selected Essays I,* Washington D.C.: International Monetary Fund, p. 25, quoting Handelsblatt, 28 June 1976.

3 18 August 1972, "Reform of the international monetary system: a report by the Executive Directors to the Board of Governors," reproduced in Margaret de Vries, *The International Monetary Fund, 1972–1978: Cooperation on Trial III,* Washington D.C.: International Monetary Fund, p. 27.

4 See Kenen, P.B. (forthcoming) "Capital controls, the EMS, and EMU," *Economic Journal.*

5 The PPP calculations involve a considerable increase in the GDP figures for less industrialized countries compared with GDP calculations based on current market exchange rates. For some time the United Nations used PPP as a basis of estimates.

In 1993, this approach was also used in the IMF's *World Economic Outlook*. See *World Economic Outlook,* May 1993, pp. 116–19. Also *The Economist,* 15 May 1993, p. 83.

6 World Bank (1991) *World Development Report 1991,* Washington D.C.: World Bank, pp. 204–5.

7 International Finance Corporation (1993) *Emerging Stock Markets Factbook 1993,* Washington D.C.: International Finance Corporation, pp. 20–1.

8 "No. 1 on agenda: the limits to promoting growth," *New York Times,* 6 July 1992, p. A7.

9 Nicholson, H. (1939) *Diplomacy,* London: Thornton Butterworth, p. 41.

10 *World Economic Outlook,* October 1993, pp. 104–12.

11 Dasgupta, P. (1993) *An Inquiry into Well-Being and Destitution,* Oxford: Oxford University Press, esp. pp. 104–28.

12 de Vries, M.G. (1985) *The International Monetary Fund 1972–1978: Cooperation on Trial I,* Washington D.C.: International Monetary Fund, p. 533.

13 Viner, J. (1951) *International Economics,* Glencoe Ill.: Free Press, 1951, p. 16. See also Elliott, W.Y. (1995) *The Political Economy of American Foreign Policy: Its Concept, Strategy and Limits,* New York: Henry Holt, p. 20.

14 See Guitián, M. (1993) "The issue of capital account convertibility: a gap between norms and reality," paper presented at seminar on currency convertibility, Marrakech, Morocco, 16–18 December.

15 See Cooper, R.N. (1984) "A monetary system for the future," *Foreign Affairs* 63:166–84; Cooper, R.N. (1991) "What future for the international monetary system?" in J.A.Frenkel and M.Goldstein (eds) *International Financial Policy: Essays in Honor of Jacques J.Polak,* Washington D.C.: International Monetary Fund and De Nederlandsche Bank, pp. 125–49; McKinnon, R.I. (1984) *An International Standard for Monetary Stabilisation,* Washington D.C.: Institute for International Economics; McKinnon, R.I. (1993) "The rules of the game: international money in historical perspective," *Journal of Economic Literature* 31

16 See De Grauwe, P., De Wachter, H., Embrechts, M. (1993) *Exchange Rate Theory: Chaotic Models of the Foreign Exchange Markets,* Oxford: Blackwell.

17 Johnson, H.G. (1972) "The Bretton Woods system, key currencies and the 'Dollar Crisis' of 1971," *Three Banks Review* 94:5. Also, for a different analogy, Borchardt, K. (1985) "Can societies learn from economic crisis?," *German Yearbook on Business History 1984,* Berlin: Springer Verlag, pp. 13–24.

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19 Solomon, R. (1989) "International monetary reform: the future is not what it used to be," in O.F.Hamouda, R.Rowley, B.M.Wolf (eds) *The Future of the International Monetary System* Aldershot, p. 10. Issing, O. (1991) *Internationale Währungsordnung,* Tübingen: J.C.B.Mohr, pp. 50–1.

20 For example, *Middle East Economic Digest,* 18 December 1992.

21 For example, Ota, F., Tanigawa, H. and Otani, T. (1992) *Russia's Economic Reform and Japan's Industrial Policy,* MITI Working Paper, Tokyo.

22 This case has been powerfully argued in Bourguignon, F. and Morrisson, C. (1992) *Adjustment and Equity in Developing Countries: A New Approach,* Paris: OECD.

3

INTERNATIONAL CHAPTER 11 AND SDR

Zhiyuan Cui[1]

> There is no American legislation against fraudulent bankruptcies. Is that because there are no bankrupts? No, on the contrary, it is because there are many.
>
> (Alexis de Tocqueville 1835:224)

> The modern legislator has been able to erect a structure of bankruptcy law wholly undreamed of by its Tudor architects. Discharge from debts, voluntary bankruptcy, enforcement of majority-determined composition, moratoria, reorganization facilities—all these are now to be found in a law that began with a brief statute directed at the pursuit and punishment of a narrow class of fraudulent debtors.
>
> (Israel Treiman 1938:190)

THE DEEPER IMPLICATIONS OF SACHS' CRITICISM OF THE IMF

Jeffrey Sachs recently made the following observation:

> It is instructive to compare the treatment received by Russia and the treatment received by Macy's Department Stores, which by coincidence filed for Chapter 11 relief in January 1992, the same month that Russia fell into default on its obligations. By law, Macy's was afforded a complete and automatic standstill on debt serving on the day of its Chapter filing, January 27, 1992. Two weeks later, Macy's obtained a \$600 million debtor-in-possession loan in order to secure working capital for continued operations. By contrast, it took Russia eighteen months to receive a partial standstill on debt serving, and the same period of time to receive a \$600 million working capital loan from the World Bank.
>
> (Sachs 1994:40)

This observation is important and insightful. However, Professor Sachs has not worked out fully the implications of his observation. It is the purpose of this paper to do so.

The first implication

The very existence of the domestic Chapter 11 refutes the conventional wisdom about market economy as a natural selection mechanism by which only the "fittest" will survive. The idea of Chapter 11 starts, historically and logically, from the premise that international financial markets are not efficient (in the technical sense of the term). If financial markets were efficient there would be no need for even the domestic Chapter 11, since in an efficient market the "good" enterprises in temporary trouble could always signal themselves out by getting higher interest loans from financial markets. The very fact that a "good" firm could go bankrupt in a market economy requires a new understanding of the nature of market economy.

We need to remember that the proof of the "Pareto efficiency" of market economy (the first theorem of welfare economics) requires the following condition: aggregation of budget constraints of firms in different states of nature into a single budget constraint. In other words, in the first theorem of welfare economics, "flow constraints" (in different states of nature) is reduced to "stock constraint." However, this reduction is only valid if all assets are liquid (i.e., easy to convert into cash) and the firm can borrow freely against its future income in a perfect capital market. When markets are incomplete, even "good" firms may be unable to borrow money from banks and equity markets. So, the reduction of "flow constraint" into "stock constraint" is impossible, and "good" firms may go "bankrupt" due to "flow constraint." Let me explain why this is so in some detail, by specifying three mechanisms operating in an incomplete set of markets.

1 Credit rationing. On first sight, people might think that "good" firms can borrow money by offering a higher interest rate to the bank, since they can produce at lower costs than their competitors. However, one of the main causes of "incompleteness" of markets is incomplete information among borrowers and lenders; so, the interest rate borrowers are willing to offer may signal their "type" (risk-lover or risk-averse). The very fact that they are willing to offer a higher interest rate may signal to the lender that they are over-optimistic about their investment project. From the point of view of the bank, this leads to, first, the "adverse selection" effect of a higher interest rate, i.e., a high interest rate attracts risk-loving applicants, thus increases default rate; second, the "adverse incentive" effect, i.e., a high interest rate induces former prudent borrowers to take on riskier projects. Due to the effects of "adverse selection" and "adverse incentive," Stiglitz and Weiss (1981) argued that the expected return to the bank may well rise less rapidly than the interest rate and, beyond some critical point r^*, may actually decline. So, the bank would not lend to a borrower who offered to pay more than the critical point r^*. As a result of this, even "good" firms may not be able to borrow money: "there are no competitive forces

leading supply to equal demand, and credit is rationed" (Stiglitz and Weiss 1981:397). Thus, this "incompleteness" of loan markets is one of the mechanisms which could lead "good" firms to trouble.

2 Equity rationing. On first sight, one may also think that "good" firms can raise money in the stock market by offering a higher dividend. However, similar "adverse incentive" and "adverse selection" effects cause rationing in the equity market. As Greenwald, Stiglitz and Weiss argued (1984:195): "First, incentive problems may intensify when a firm is equity financed. Managers, who receive only a small fraction of any additional profit, are likely to put forth less-than-optimal effort.... Second, signalling effects may restrict a firm's access to equity markets...[because] attempting to sell equity may convey a strong negative signal about a firm's quality and reduce its market value accordingly." Therefore, firms have very limited access to the equity market, even if they are "good." In fact, in all major Western countries, only a very small fraction of new capital is raised by new equity issues.

3 Multiplier effect and recession. Credit and equity rationing are two mechanisms which may prevent "good" firms from being able to borrow even in normal times. These are "individual shocks" to the good firms. However, there is also "aggregate shock": more "good" firms go bankrupt in times of macroeconomic recession. It is difficult for believers of the "invisible hand" paradigm to explain the existence of recession, because, according to this paradigm, flexible price reactions tend to smooth out initial disturbance, thereby ensuring that individual shocks will not multiply into aggregate recession. But, from the perspective of incomplete markets, credit and equity rationing can have multiplier effect, which leads initial disturbance to recession. Once again, as Stiglitz points out, an economic disturbance (regardless of its origins) "results in higher than anticipated defaults, lowering banks' net worth. This, combined with the greater uncertainty associated with lending, reduces their lending activity, amplifying the economic downturn" (Stiglitz 1992:292).

We have seen, therefore, that (at least) three mechanisms—credit rationing, equity rationing and their multiplier effect on recession—are responsible for "good" firms going bankrupt. This explanation is based on the logic of the "incomplete markets" theory and is consistent with the historical facts about the development of bankruptcy law in history.

The crucial historical stage in the development of bankruptcy law was the introduction of "reorganization" provisions in the 1898 Act. This "reorganization" stage began with the Wabash Railway receivership of 1884. On 28 May 1884, Jay Gould president of the Wabash Railway, requested the federal district court in St Louis to appoint his representatives to be receivers of the still solvent Wabash Railway. This was a completely unprecedent request. As Gerald Berk put it, at that time, "nowhere in the available theories of the corporation or in receivership practice could a justification be found for putting a corporation into receivership prior to default, or for appointing its managers to job of receiver" (Berk 1990:141). The court agreed with this unprecedented request, which marked the beginning of "reorganization" practice. By "reorganizing" Wabash Railway, Jay Gould "was able to wring enormous concessions from his creditors: both principal and interest were slashed substantially in the final settlement" (Berk 1990:144).

From my perspective, what is significant about this story of Wabash Railway receivership is the argument used by Jay Gould and his supporter in court. Basically, they argued that liquidation may put society at large in jeopardy: "if the lines of road are broken up and fragments thereof placed in the hands of various receivers [creditors], and the rolling stock, materials, and supplies seized and scattered about, the result would be irreparable injury to all persons having any interest in said line of the road" (Berk 1990:144). The inherent validness of this argument is beyond the scope of this paper. My point here is to highlight that the very justification for "reorganization" was, as a matter of historical fact, the interest of society at large. Influenced by the 1884 Wabash Railway "management receivership" (rather than traditional "creditor receivership"), and pushed by the financial depressions in 1885 and 1893–7, the 1898 Bankruptcy Act explicitly included "reorganization" provisions.

Similarly, the 1938 Chandler Act (amendment to the 1898 Act) was also the result of the concern for saving "good" firms that were in a bad general financial situation. It is well known that the first legislation sent by President Roosevelt to the Congress was The Emergence Banking Act of 1933, in which he legalized a nationwide "banking holiday" (i.e., a shut down of banks), which he declared two days after his inauguration. Obviously, saving "good" firms in this general financial distress was the motive of the Chandler Act of 1938, which made it easier for firms to file for reorganization; because, as James Olson pointed out, "a national holiday without a sound reorganization plan would be foolish" (Olson 1990:37).

The second implication

The international counterpart to the domestic Chapter 11 should also be based on an understanding of the inefficiency of the foreign exchange market and the Euro-Dollar markets as means of providing international reserve assets and financing balance of payment, especially for developing countries. There are several reasons for this:

1 Despite the rhetoric of the new age of global economy, there are plenty of signs today which indicate that we are repeating the dangerous game of "competitive devaluation" of the interwar period. The worldwide currency chaos in mid-September 1992 and the US effort to undercut the competitive advantage of foreign producers through exchange rate

manipulation (such as advocating a sharp rise in the yen to reduce Japan's competitiveness) are just two recent, startling examples of this sort.

2 Many developing countries are too small to be optimal currency areas. The costs of floating their exchange rate exceed the benefits.
3 EMS for European countries is not available for developing countries, and this makes the international Chapter 11 even more necessary for them.
4 The Eurocurrency market is too costly a way for developing countries to create their international reserve asset, due to similar problems of "credit rationing" and "equity rationing" discussed above in the domestic context.

SDR AS A CRUCIAL DEVICE IN INTERNATIONAL CHAPTER 11

What are the technical devices for the international Chapter 11? Let us look first at the domestic Chapter 11. Chapter 11 under the 1978 Bankruptcy Reform Act has only minor differences from the 1938 Chandler Act. As before, the firm can choose voluntarily to file for liquidation under the Chapter 7 or for reorganization under Chapter 11. According to Chapter 7, the bankruptcy court appoints a trustee who shuts down the firm, sells its assets and turns the proceeds over to the court for payment to creditors; however, according to Chapter 11, the existing managers of the firm usually remain in control and the firm continues to operate. During the first six months after the bankruptcy filing (and length extensions are often granted), only a plan proposed by management can be adopted. More importantly, firms reorganizing under Chapter 11 have the right to terminate under-funded pension plans, and the government picks up the uncovered pension costs. Also, their obligation to pay interests to pre-bankruptcy creditors ceases. Moreover, "firms that reorganize retain most of their accrued tax loss carryforwards, which would be lost if they liquidated. These loss carryforwards shelter the firm from having to pay corporate profits taxes for a period, even if their operations start to be profitable."

The trouble is there is no counterpart at international level to this unconditional tax-relief of domestic Chapter 11. This observation leads me to think of SDR as a crucial device for the international Chapter 11—because the allocation of SDR is unconditional.

SDR (Special Drawing Right) was created in the 1968 Rio de Janiero Agreement as a form of international liquidity to supplement a nation's official reserve holdings of gold, dollars and IMF quotas. Later, the IMF stipulated SDR as the principal reserve asset. It is not backed by any specific reserve held by an issuing authority. It is backed only by the mutual commitment and confidence of IMF member countries. In this respect, SDR represents the first triumph of "world money"—the "denaturalization" of the medium of exchange in human societies. In order to understand the nature of SDR better, let us trace the history of the idea and practice of "world money" and "world central bank."

Keynes required his "clearing union" to operate on the basis of a world money, which he named "Bancor." It was not in conflict with Keynes' concern for national economic sovereignty. Why this is the case is illustrated by his design of the clearing union: each country would denominate its national currency in terms of the international clearing union's unit of account (i.e., Bancor), which could be expressed in terms of gold; however, gold would only be convertible into Bancor in one direction—a national central bank could increase the balance on its account with the international clearing union by selling gold but it could not reverse the process. This made Bancor the ultimate reserve asset in the world. Then Keynes gave each country a quota (equal to half of the average sum of the country's exports and imports over the previous five years) and allowed countries overdrafts against this quota. This overdraft facility, in contrast to the subsequent IMF conditionality (which was not in the original Articles of Agreement in 1944!), leaves a large space for national economic experimentation.

In national contexts, the "clearing house" was historically the prototype of the central bank. In fact, today's IMF already possesses some limited functions of a world central bank. First, the IMF can create international money in two ways:

1 Its lending operations at the initiative of a borrowing country can in turn create a "reserve position" for the country whose currency has been drawn; this reserve position then be drawn by that country;
2 The IMF can issue new SDRs.

Second, IMF can perform the lender-of-last-resort function when it waives the quato for a particular country in extreme balance of payment trouble.

However, the potential of the IMF as a world central bank (based on SDR as a major international reserve asset) is not fully realized. In fact, this potential has been blocked by the developed countries. Since 1970, SDR has been issued only twice. As mentioned earlier, the developed countries have more resorts (such as EMS and Euro-Dollar markets) to smooth their balance of payment; they are not desperately in need of SDR as an international reserve and as international liquidity. But for most developing countries, SDR represents the hope of an international reserve and of international liquidity, because it is much better than other sources of international financing.

Theoretically, SDR is better than gold or dollars as an international reserve asset. This can be seen as an implication of the "Triffin Dilemma": keeping the US dollar as the global liquidity device required continuous US balance of payment deficits, but the long-term stability of the dollar depended on

America's ability to return to surplus. An equivalent way of stating the "Triffin Dilemma" is, when dollar is backed by gold the growing worldwide dollar holdings mean the ratio of US gold reserves to US external liabilities is declining. Also, when a particular country's currency is used as an international reserve that country's domestic policy will unduly influence the fate of other countries. This is part of the reason for the debt crisis of the Third World.

Therefore, in order properly to establish the international Chapter 11, the necessity of which was implied by Jeffrey Sachs' criticism of the IMF, we must use SDR as a crucial device of international liquidity and international reserve. In his recent speech, Michel Camdessus, the Managing Director of the IMF, argued strongly for a new allocation of SDR (*IMF Survey,* 3 May 1993). However, he asked only for "voluntary" reallocation of SDR from developed countries to developing countries. It is the belief of the present author that we must go further so as to make SDR a really meaningful device in the international monetary system, especially in the creation of the international Chapter 11.

NOTES

1 I thank Roberto Unger for many useful discussions, though we reach different conclusions from the same premise.

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4

REGIONALISM *VERSUS* GLOBALISM?

Globalism *via* regionalism!

Reimut Jochimsen

INTRODUCTION

Economists tend to regard globalization, implying ever more open markets, as a positive development per se. They see the promise of a stronger role for the forces of competition, and the more effective channeling of human and other resources into those activities where productivity is greatest. By way of contrast, they take a skeptical view of regionalization, with its implied geographical segmentation of markets, suspecting that such groupings intend to hold up the welfare-enhancing globalization process in favor of particularized interests. If this admittedly rather coarse distinction between globalization and regionalization holds true, the international trade and monetary policy agreements concluded fifty years ago in Bretton Woods surely deserve the highest merit. The historical circumstances of the Second World War (still in progress at the time), the experience of the competitive devaluations of the interwar years, which had shaken the world economy to its foundations, and the fact that world policy structures were still malleable, apart from the USA's unqualified position of supremacy (also excluding the Soviet sphere of influence then developing, which was to remain on the outside until 1989): all of these factors made it easier for the politicians of the day to commit themselves on such an extensive scale to a surrender of sovereignty to global institutions.[1]

Once again today, we find ourselves at the dawn of a new epoch. The East—West conflict of the last forty-five years, and three-quarters of a century of ideological and practical division are now all over. Nation-states have been resurrected in the East, though they are not yet viable and some are still in the perils of ethnic upheaval and disintegration. As a parallel development, we are witnessing an undiminished globalization in economic relations, the growing international division of labor, and increased penetration of communications and technology on all levels. Nevertheless, the road toward a universality that neither includes nor tolerates any totally sovereign, closed economies and societies within nation-states is a stony one with many twists and turns. The Uruguay Round, like the Rio Conference, revealed that again for all to see, as shall, most likely, the Cairo Conference on Population. In the end, though, it did bring us a little closer to the global aim of open markets.

In the monetary sphere, we have now lived for two decades with exchange rates that are, in principle, flexible. Though their reintroduction was considered a failure at the time, they are, in fact, quite in keeping with the model concept of a global competitive order. Yet there are many who regard the monetary status quo in the world economy, with its violent exchange rate fluctuations and interest rate movements, as a state of pure anarchy to which, for the sake of growth and employment, we ought to put a stop, especially as it also appears to generate excessive costs for international trade and capital investment. Not all lessons have yet been learned, or implications understood, from this experience.

THE IMPLICATIONS OF FLEXIBLE EXCHANGE RATES

Of course, also before the Bretton Woods system of fixed exchange rates was hooked off its golden anchor in August 1971 and effectively dissolved in the Spring of 1973, many economists had voiced the expectation that the transition to a system of floating rates would ultimately have more advantages than disadvantages for the stability of the world's monetary system and for steady growth, trade, investment and employment.[2] There were essentially three arguments which the protagonists of unpegging exchange rates had been putting forward for a long time:

- Flexible exchange rates would allow countries to be almost totally autonomous in their national demand management and stability policies.
- Exchange rate fluctuations would normally be dampened by the stabilizing effects of arbitrage and other, speculative, market activities.
- The associated low level of exchange rate volatility would not present any serious impediment to international trade.[3]

None of these propositions has withstood the test of the real world. For example, it has proved a vain hope that the international interdependence of interest rates might be decisively loosened by flexible exchange rates, thus allowing greater scope for the use of monetary policy for countercyclical purposes. Moreover, exchange rate fluctuations since that time have been several times greater than they ever were during the Bretton Woods era, which has tended to impair and lower macroeconomic efficiency. The key problem in this respect has not so much been the increase in shortterm volatility as the long-persisting deviations in real exchange rates from a level or track justified by economic fundamentals (however they are defined).[4]

The 1980s provide a good example of this "misalignment," the US dollar appreciating by 92 per cent against the deutschmark, from 1.7236 DM/$ in January 1980 to 3.3090 DM/$ in March 1985, but subsequently dropping back to only 1,4870 DM/$ in November 1990—in other words, losing more than half of its value once again (rates quoted are monthly averages of daily closing rates: the first absolute low was 1.7062 on 3 January 1980, the absolute peak was 3.469 DM/$ on 20 February 1985 and the absolute trough 1.387 DM/$ on 9 September 1992). This pronounced volatility in exchange rates during the 1980s was not in the least justified by economic fundamentals and especially not by differentials in inflation rates.[5]

Exchange rate swings of this magnitude undoubtedly have negative consequences for resource allocation, trade and investment, and hence also for growth and employment. The present track of dollar/yen exchange rates has again showed us that the problem of long-term overshoots in real and nominal exchange rates has by no means been banished in the 1990s. To make matters worse, persisting balance of payments disequilibria and the associated exchange rate distortions frequently create a dangerous degree of protectionist pressure. It is no coincidence that measures to impede imports (of the kind now threatened against Japan in the US Trade Act's "Super 301") have been resorted to particularly by that country since the 1960s at times when the dollar was overvalued, as one way of implementing a fundamental correction of bilateral trade flows. Misalignments therefore harbor the danger that welfare-enhancing progress in the liberalization of world trade will be jeopardized, and also that the exchange rate will be allotted industrial-policy and trade-policy functions.

CAUSES OF FAILURE OF THE BRETTON WOODS SYSTEM

Before going on to assess the reform proposals put forward so far, I believe it is necessary to take at least a glance at the causes of the original failure of the Bretton Woods system, as they may hold the key to the core elements of a more stable global monetary order.

The background to the end of the Bretton Woods system was that a number of industrial countries were having persistent problems in eliminating balance of payments deficits (or keeping underlying domestic economic developments in tune with the international economy) by taking appropriate policy measures or by changing their currency parities in good time. This applied particularly to the USA, which, it was also assumed, did not have the option of devaluation because of the dollar's role as the base currency for the Bretton Woods system of fixed exchange rates. Yet the economic policies pursued by the USA in the late 1960s, including welfare state programs and funding the Vietnam War, proved to be more and more irreconcilable with the dollar's function as the world's lead currency.[6]

It is often maintained that the Bretton Woods system broke down because of its own rigidity. However, I do not believe that any earlier readiness to make more frequent realignments would have been sufficient to save the system. Furthermore, since that time, a number of crucial paradigms inherent in the original Bretton Woods system have changed substantially or have been superseded by new ones. There is thus all the more reason not to reestablish a system which has failed.

The world's financial markets have undergone revolutionary changes, particularly in recent years. National financial markets have now largely been liberalized and deregulated and are growing much faster than the real economy, making them ever more global and—with the aid of electronic communications and financial innovations—ever swifter and more potent. The volume of capital movements has grown in leaps and bounds, while financial assets have become increasingly detached from their foundations in the real economy and exploded to vast proportions.

Every day, more than one trillion dollars flows across the world's major foreign exchange markets, an amount approximately twenty times as large as the volume of international trade and service transactions; thus the financial movements of today have put paid to the idea that trade transactions are the main moving force in the world economy.

Portfolio managers operating internationally have now become incredibly sensitive to the tiniest changes in macroeconomic variables and still more to the overall judgment of countries' economic and budgetary policies which might provide an indication of future changes in such "fundamentals."[7]

Any incongruities between economic policies or economic performances which were linked via a fixed exchange rate system would be mercilessly exposed by today's largely deregulated, high-tech world financial markets and would be responded to by massive waves of speculation. The European Monetary System's crises of 1992 and 1993 provided us with telling examples of this drastic change. And the challenges of a delinking of fundamentals have not, of course, been banished simply by loosening the rules of intervention.

Apart from that, there is another important difference between today and the international fixed exchange rate system at the time of the gold standard or, later, the gold-dollar standard. The dominant role then was played by a currency's external stability, to which internal stability (i.e., the real value of the currency in its home market) was forced to adjust by way of fluctuations in price levels, output, wages, employment, etc., in order to reestablish external equilibrium. This has now changed decisively. In the Treaty of Maastricht, for the first time, as far as I am aware, in an international treaty, ensuring internal stability in the value of money has been laid down as the primary objective of monetary policy, which must act to stabilize prices in the currency zone, and exchange rate policy is subordinate to that prime aim. Furthermore, monetary policy has been charged to focus fully on price level stability, presupposing that policies will likewise concentrate their instruments on contributions toward this goal of monetary stability and pressing them to do so. This draws on both the experience of West Germany monetary policy since 1948 and the consequent creation of the EMS, where the deutschmark serves as the anchor currency. Thus Irving Fisher's principle of stabilizing the (domestic) purchasing power of money has finally asserted itself. Following the bitter experience of high and divergent inflation rates in recent decades, we now for the first time have an agreement which is binding under international law for the twelve member states, hopefully soon to be sixteen. This has reversed the old sequence of priorities, reappraising the arbitrariness of the combination of the magic triangle's goals into a new profile of achievement and performance goals (Gerhard Colm). Without question, in the old days of the international gold standard it was principally excluded, by the system itself, to concentrate efforts solely on a domestic monetary target, while the paper currencies, with their inflationary tendencies, had yet to find proper objectives to follow.

It is important to realize that even the Bretton Woods fixed exchange rate system, by working on the assumption that domestic economic policies would be appropriate to meet the needs of ensuring the fundamental equilibrium conditions for each member country, really only evaded this immanent conflict of objectives rather than resolving it. If domestic economic policies were not appropriate, an exchange rate realignment became unavoidable, which is where an asymmetry in the mechanism of the IMF to the detriment of debtor countries (and to the benefit of creditor countries) shows up, and that same asymmetry still exists in the EMS today, giving the prize to the country with the strictest discipline.

REFORM PROPOSALS SO FAR UNDER DISCUSSION

Of the various reform proposals for stabilizing exchange rates under discussion, the target zone concept has so far had the most favorable hearing among monetary policy-makers.[8] Although a construct of this type has certain merits thanks to its theoretical purity,[9] it would be bound to fail when it came to implementing it. Right at the outset, the calculation of a "fundamental equilibrium exchange rate" by a national or international body, such as the IMF, as proposed by John Williamson[10] and Fred Bergsten,[11] could be expected to trigger off controversies. A particular reason for this would be that any such predefined rate could be derived only from normatively determined targets for the current and capital accounts of the balance of payments; indeed, even the determination of so-called purchasing-power parities could, at best, only offer a certain amount of orientation for the longer term.

A more problematic aspect, however, is that the target-zone concept and other reform proposals too—such as the Tobin tax,[12] a harmonized world money-supply policy *à la* McKinnon,[13] or a worldwide currency system modeled on the EMS[14]—would all be predicated upon an extraordinary effort of willpower to aim for worldwide coordination, at least of macroeconomic policies, and also upon the existence of wide areas of common ground in the notions and practical implications of economic policy practised in different continents and countries, to a degree which simply does not exist yet on this globe and which is unlikely to materialize in the foreseeable future. Least of all, America, which matters most, is willing to subordinate domestic economic policy to international obligations. The practical difficulties of such obligations one can witness actually in the EU trying to fulfil the convergency criteria stipulated by the Maastricht Treaty, to appreciate that these are maximum tolerable figures, not just to be reached once or twice, by "friendly" stretching or by historical accident, but permanently. In contrast to the progress which has been made in reducing trade barriers around the world, with the GATT rounds always allowing a step-by-step approach to be followed, even just budgetary and monetary policies are very difficult to coordinate on such a gradual basis, since such moves often give rise to doubts in the marketplace as to the credibility of whatever measures are announced.[15] A coordinated economic policy with the intention of stabilizing exchange rates around the world involves jumping in at the deep end, for a bold step has to be taken in which binding agreements are reached to surrender a certain amount of present-day national sovereignty. I have to agree with the US Treasury Secretary, Lloyd Bentsen, when he judges that this kind of approach would be difficult to enforce.[16]

PRAGMATIC APPROACHES TO EXCHANGE RATE STABILIZATION

Given that we cannot realistically expect the necessary conditions for a viable global system of fixed exchange rates to be attained, pragmatic approaches to exchange rate stabilization are now called for. Many smaller economies, instead of adopting an autonomous monetary policy strategy, which they would in any case be unable to defend on open financial markets, have chosen to pursue an exchange rate objective, thus placing their trust in the stability policy of the country with the anchor currency chosen.[17] However, this approach could not serve as a model for a global currency system, or not at least unless the USA was willing to "rise to the task" of such a stable, anchor role once again, and to me that does not seem to be within the bounds of possibility on either count at the present time. Moreover, both the deutschmark and the yen have now taken up such important positions in the international capital markets that the dollar would not now be by any means the sole, undisputed candidate for the role of a global lead currency.[18] So we are still left with the questions of whether any country, and if so which one, can provide the "*n*th currency," i.e., perform the anchor role, and of how the stability of that currency can be credibly secured.

Another proposal draws upon Europe's experience with the integration of monetary policy. The prime purpose of the European Monetary System (EMS) which began operation in 1979 (as a successor to the "currency snake" set up in 1972) was to establish a zone of fixed but adjustable exchange rates between the countries of the European Economic Community (EEC), which were already relatively highly integrated in terms of their mutual trade.[19] Remember, as long as the Bretton Woods system continued to function, the desired monetary accompaniment to the integration of the real economies of Europe appeared assured—at least as far as the settlement of current payments was concerned, following the establishment of dollar convertibility for the West European currencies in 1958. It was not until the fixed-rate system spanning the Western world broke down that the Europeans had the need—from the viewpoint of preserving the integration already achieved in the real markets and continuing with the integration program—for a low-up system of their own, albeit a regionally limited one. That need appeared all the greater since the mark had been moving increasingly strongly into the role of a substitute reserve currency, which might be considered as an alternative to the dollar. This antipodean position meant that the mark regularly tended to be affected by the ups and downs of the US currency much more severely than the other European currencies were, which repeatedly made it a disruptive factor within the EMS. It was hoped that a concerted monetary-policy stance in the Community would get round this problem. When, from 1983 onward, this did indeed succeed to an increasingly convincing degree, it provided the basis for deepening Western European integration via the program to establish the single internal market by the start of 1993.

Unfortunately, the hopes placed in monetary policy (and, indeed, in the Single Market) have been fulfilled only to a certain extent. Five realignments in its first three years alone and seventeen in the EMS's history to date, involving successive revaluations of the deutschmark against the partner currencies (48 per cent against the French franc alone since March 1979) were not especially conducive to spreading the burden of Europe's counterpole to the dollar on to the shoulders of the other EMS member currencies. Germany's undisputed dominance of the EMS in terms of stability, at least up to the time of reunification, fostered still more the partner nations' long-held desire to "prize out" the deutschmark's unloved leading role by means of monetary union, as it was succinctly put by Professor Szász, Vice President of the Netherlands' central bank.[20]

THE LINKS BETWEEN MONETARY STABILIZATION AND NATIONAL ECONOMIC AND POLITICAL INTEGRATION

Experience in Europe with the establishment of a fixed exchange rate system has shown that any nominal stabilization of rates which is not founded on fundamentally convergent national fiscal policies and also on wages policies—in such a closely integrated common market, with its high degree of mutual interpenetration by trade, direct investment, joint market organization and transborder mergers—will be impossible to maintain in today's borderless financial markets. Capital mobility has been increased right to its upper limits while intra-EU labor mobility still remains relatively limited. So here again, the "age-old laws" are proved true, and one has to agree with Wim Duisenberg when he urges that, to attain lasting stabilization of exchange rates and convergence of interest and inflation rates, one needs to have not only a credible monetary policy and sound budgetary policy, but also a responsible, productivity-oriented approach to wage and salary levels.[21] And add to this the requirement to avoid an excessive current account deficit on the balance of payments. Only when these conditions have been met will a currency be out of danger of falling into the vicious circle of devaluation and inflation.

If, on the other hand, those conditions are not fulfilled, any central bank intervention will amount to no more than trying to treat the symptoms without being able to eliminate the root causes of the malaise. The EMS member countries did not find it easy to take on board the fact that such automatic intervention responses, even if they had no *formal* upper limit in volume terms, could neither be a substitute for a country adjusting its own fiscal and incomes policies, nor could they in time produce the necessary adjustment processes off their own bat. In reality, the decision-making processes involved in such policies and their other causes all operate more or less autonomously without making automatic responses, so an exchange rate mechanism cannot bring about the changes needed as a *deus ex machina*. In fact, it generates and increases the very danger that the guardians of the currency will be unable to meet their fundamental objective, i.e., to secure stability in the level of prices.[22] In any case, unlimited intervention is liable ultimately to fail, either due to a lack of convertible currency reserves or because intervention on such a scale itself runs counter to or even destroys the bank's own monetary policy.

Fred Bergsten is mistaken when he judges this to be a weak excuse on the part of the monetary authorities.[23] In the one month of September 1992, the Bundesbank alone made DM92.5 billion (approximately $64.4 billion) available to support the partner currencies in the EMS. Yet even that was not enough to save the parities at the time, particularly as the move to "get out" of the home currency in the United Kingdom and Italy already seemed to have carried—beyond banks and exchanges—everyone along with it. We did succeed, it is true, in soaking up the "high-powered money" arriving in our banking system almost on a simultaneous basis and keeping it out of circulation. However, to the extent that domestic non-banks were also involved in the process of restructuring currency portfolios in the course of the market upheavals, this did still lead to a strong primary (expansive) impact on money supply. In other words, operating such a system cannot be a matter of reserve banks simply supplying one another *ad infinitum* with a sufficient mass of funds for market intervention: the absolute prime consideration ought to be what consequences such action will have for money supply and price stability in a bank's home economy.

To that extent, it would seem that exchange rates can only be stabilized successfully in parallel to an increasing harmonization of national economic policies, preferably by way of deeper economic and political integration. Not until success is achieved in quelling the uncertainty of the markets by means of coordinated, consolidated policies which are conducive to stability can we also expect exchange rate developments to be steadier over time.

This doctrine is indeed now increasingly being followed by the countries participating in the EMS exchange rate mechanism (ERM). In spite of having widened the exchange rate bands (to trigger off automatic mutual intervention duties by the central banks concerned) to +/–15 per cent—a move accompanied by a good deal of derision at the time—rate movements on the foreign exchanges have been remarkably calm and stable since last Fall. The reason is that the ERM partners have maintained both an internal and external stability orientation which has surprised many a market participant and which has been underscored by the recent moves of granting a more autonomous status to participating national central banks. Nevertheless, it is still early days and too soon to make a final judgment. The EMS's condition will be regarded as unstable at least until such time as the mark, as its lead currency, can resume its full role as the most stable of the currencies and as long as the higher unemployment associated with the need for countries with more stable prices to follow Germany's lead on interest rates is viewed by the markets as problematic.

However, the European example of a regional currency agreement does provide a perfect illustration of, on the one hand, the need for a parallel approach to political and economic policy integration and, on the other, monetary and currency policy integration. The fact that this link is a *sine qua non* was the fundamental idea underlying the Maastricht Treaty which, whatever its deficiencies in the final text,[24] was a pioneering achievement in this respect.

REGIONALISM *INSTEAD OF* GLOBALISM

On the basis of European experience, the obvious way ahead would initially appear to be to go for regionalism *instead of* globalism in future coordination efforts. The suggestion is based on the realization that a global solution to the currency problem or, in other words, a simple reinstatement of the 1944 Bretton Woods system, is impracticable and untenable as things look today. A way out of the dilemma might be offered if not only the European Union but also other trade blocs from around the world (NAFTA, ASEAN, MERCOSUR, etc.)[25] were to step out along the road to monetary policy cooperation in parallel to their integration in the real economic terms of trade and investments beyond a free trade arrangement. There are a number of self-evident advantages to such a strategy:

- The process of integration is both widened and deepened as a result.[26]
- Economic policy harmonization is easier to achieve within a small, regionally delimited group than it is on a global scale.[27]
- The greater willingness to cooperate in regional agreements also flows from the greater economic and political interconnections between the countries involved.[28]

However, on closer inspection, a number of disadvantages of a regionalization strategy also become apparent:

- A regional approach, too, can only suppress rather than solve the problems arising from the effects of exchange rate fluctuations.[29]
- The problem of the borderlines between regional currency blocs remains unresolved, and volatility in the exchange rates between the blocs seems inevitable. (Optimal zones are rare.)
- The concept of developing regional blocs for trade, investment and monetary policies harbors considerable protectionist dangers for worldwide free trade and its welfare-enhancing effects ("Fortress Europe," NAFTA).[30]

GLOBALISM *VIA* REGIONALISM

The fear that the world economy might degenerate into a number of multipolar fortresses should certainly be taken seriously. On the other hand, as I have said, the necessary foundations are not available for a formal "reinvention" of the Bretton Woods system as a world-embracing monetary order. Those foundations have yet to be created, even though the global character of the international economy and the universal patterns of interdependence are ever more obvious and indisputable, partly also because the ecological dimension, not to speak of human rights and the labor standard, demonstrates itself to be a global one. Yet the process of creating those foundations is not merely a question of "institutionalization," for today's world calls for more than that in order to apply and implement a system: consistency of objectives, effective cooperation, real, lasting convergence and earned credibility of stability endeavors. Despite all the unforeseeable problems involved, it nevertheless seems to me that one ought to consider rejecting the proposal of regionalism *in place of* globalism, reformulating the idea of "regionalism *versus* globalism" to read "globalism *via* regionalism." Such a strategy would consist in first attaining monetary policy cooperation in intra-continental groups (among neighbors as it were) and other affiliates, preferably where economic interactions were well developed and an optimality criterion for a currency zone could be applied. In this context, regionalism should not at all be considered as an opposite of globalism but rather as a preliminary stage along the road to it.[31] In particular, regional currency blocs, which also provide the closest approximation to an optimum currency zone, would act as "learning and training areas" for a cooperation between member countries which would intensify over time.

Within regional systems operating with fixed but adjustable parities, the threat of waves of speculation would, of course, remain. However, experience has shown that this ought to be seen not only as a risk factor but must also be properly perceived as a disciplinary element and as an indicator of yet insufficient convergence. In other words, waves of speculation do not normally engulf us as an unpredictable, inexplicable *force majeure* but generally have their root causes in policy failures, some of which have been present for quite some time, some of which have been critically worsening, like national budget deficits in Europe and other industrial economies, and which are, for the most part, structural rather than cyclical and are those to which financial markets are increasingly pointing to.

The critical weakness in all fixed exchange rate systems which have so far operated, including regional ones, is the problem of adjusting parities to reflect changed or changing ratios in the long-term economic fundamentals. The bitter pill the political decision-makers would have had to swallow if they had had to confess, several times over, that their policies had been inimical to stability and that their currency really needed to be devalued led to a state of affairs in the EMS after 1987 in which realignments were blocked for several years for political reasons. Exchange rate shifts always tend to get blown up into questions of national prestige, and only the USA sems to be sufficiently at ease with itself for this issue to recede into the background ("benign neglect"). These problems might also be more effectively dealt with if the creation of autonomous reserve banks committed to pursuing stability as their prime objective were to be incorporated as an essential element in the strategy of exchange rate stabilization in an environment of open financial markets and if those banks were granted exclusive powers to manage exchange rates. If that step were taken, any adjustments required in central rates could be *depoliticized,* which, hopefully, would also mean they were *dedramatized.* Of course, such a system would work only if the reserve banks involved had already built up a sufficient reputation.[32]

At least for the time being, exchange rates among the regional currency blocs would have to remain flexible, as the "global players" cannot be expected, in the foreseeable future, to develop the political will, the readiness or the capability to coordinate and cooperate to a sufficient degree to introduce fixed exchange rates worldwide. At present, this would indeed be irresponsibly adventurous. Nevertheless, continued efforts should be made *via* existing organizations on a multilateral level to intensify harmonization, particularly in the fiscal policy field; however, in areas of incomes policy, too, countries ought to keep their eyes open to what is happening elsewhere. Only then, once participants in the regional blocs have achieved sufficient stability in the essential areas of real and nominal convergence and are speaking with one voice, will it be possible to consider taking the next step.

And in the EU, of course, we are still ahead of the most important step and stage—which does presuppose much more cohesion, lived convergence and also solidarity of nation-states or supra-national institutions than was imagined at the time of the drafting of the Treaty arrangements of Maastricht. Sustainable integration—and not foreseeable collapse for lack of political foundations and unionization—should be based on solid foundations, for this ambitious political program. The emancipation of markets—and thus the limits of populism, voluntarism and decisionism by means of political constructs—are, it seems to me, nowhere more prevalent today than here.

APPENDIX

A Road Strewn with Obstacles: Stages in European Monetary Cooperation. Efforts to create a zone of stable currency ratios, in Europe at least, led to the first institutionalized agreement in April 1972 when the "snake in the tunnel" was established. Just two months later, the British pound left the snake, and when the deutschmark's fixed dollar exchange rate was abandoned in March 1973 the participating currencies went over to a joint floating system (the "European currency snake"). Even then, in the 1970s, the problems associated with an asymmetrical exchange rate system were soon manifested. The lack of coordination between national economic policies made it impossible to maintain the exchange rates agreed among the currency bloc's participants in the long run.[33] The problem was still not solved satisfactorily in the European Monetary System established in 1979. Yet, by the end of the 1980s, it did begin to look as though Europe had developed a truly stable monetary order. Some authors at the time were so convinced of the supposed success of the EMS that they already began to regard this as a model of a new global currency system.[34]

However, in September 1992 things came to a head on Europe's foreign exchanges, as some pundits had expected to happen some time sooner. As in the Bretton Woods crisis, the crucial disruptive potential was seen to stem from the fact that economic policies in the EMS participating countries had not been sufficiently convergent for a protracted time period. The inflation differentials which persisted among the EMS members up to the early 1990s generated an adjustment backlog in nominal exchange rates and, after five and a half years during which time no parity changes had been made,[35] the corrective action was forcibly brought about by the markets. The pressure building up against the refusal to make realignments was heightened by the deregulation of financial markets under the single-market program, and the continuing development of international communications systems added its own impetus. Among the reasons why this speculative pressure had not burst out earlier was the fact that investors, expecting a fully-fledged monetary union to be established in due course, had begun to ignore exchange rate risks and to gear the management of their portfolios primarily to nominal interest rate differentials. The paradoxical result of these expectations was that the rather unstable currencies, whose interest rates were consequently the highest, became the strongest currencies within the EMS exchange rate mechanism—a truly perverse situation.

However, the mood changed drastically when the Danes voted "No" to European Union in their June 1992 referendum to ratify the Maastricht Treaty on Economic and Monetary Union, and optimism gave way to uncertainty in the run-up to France's referendum. From that moment on, market-makers were again aware of the devaluation risk associated with the currencies of countries which had not performed well in stability terms. So the price of the policy failure—i.e., the refusal to realign—now had to be paid, shattering the illusion that a system of "politically guaranteed" fixed exchange rates with unlimited central bank intervention might provide longer-term scope for countries to "go it alone" in their monetary policies.

The wave of speculation occurring in mid-1993 which eventually led to the extension of the exchange rate bands on 2 August (while central rates were left unaltered) provides a classic example of expectation-induced portfolio shifts and the rate movements which result. In the early Summer of 1993, France's new government and the National Assembly were discussing whether, in view of the massive burden of unemployment, the nation could afford to hold on to the *"franc fort"* policy and the strict orientation to the Maastricht convergence criteria; similar strategic decisions were also being debated in other European countries.[36]

NOTES

1 That this euphoric sense of a new beginning was only short-lived became clear just a few years later when the US Congress refused to ratify the Havana Charter in 1948, thus preventing the foundation of an International Trade Organization.

2 For just two of the numerous advocates of flexible exchange rates, see Friedman, M. (1953) "The case for flexible exchange rates," in M.Friedman (ed.) *Essays in Positive Economics,* Chicago, p. 157, and Johnson, H.G. (1969) The case for flexible exchange rates, *Federal Reserve Bank of St. Louis Review* 51 (6): 12.

3 Indeed, it was even believed that more pronounced integration effects might operate because the automatic equilibrium in foreign exchange flows would obviate the need for the dirigistic intervention which characterized the Bretton Woods system.

4 Still the most commonly applied definition of a fundamentally justified exchange rate is derived from the theory of purchasing power parities in an absolute or comparative form. The concept of purchasing power parity also plays an important part in discussions among the staff of the Bretton Woods Commission on the reform of the world monetary system. One of the ideas discussed, for example, is a flexible target-zone concept, in which the currency band would be adjusted for inflation differentials by means of a form of crawling peg ("The report of the staff of the Bretton Woods Commission," unpublished manuscript, 6 June 1994: p. 16).

5 Viewed in terms of retail prices, the dollar ought actually to have been devalued against the deutschmark by 1.89 per cent per annum during the first period and by 2.72 per cent per annum during the second.

6 The "Great Society" welfare programs and the escalating war in Vietnam produced increasingly large budget deficits in the late 1960s, fueling inflation and at the same time confronting Americans with increasingly high current account deficits. Because the dollar's role within the Bretton Woods fixed exchange rate system made it both the anchor currency and the predominant reserve currency in the world economy, it initially appeared to be no problem for the USA to finance its net imports of resources by simply printing more money. However, that meant that the US government had subordinated the domestic and external stability of the currency to its own economic and fiscal policy objectives. In the long run, this policy preference was irreconcilable with the dollar's anchor role in the world monetary system. It was only a matter of time before the markets began to harbor doubts that the dollar—gold parity would be upheld and the USA found itself compelled to suspend the obligation to exchange dollars for gold when called upon to do so by foreign reserve banks (15 August 1971).

7 Immediately after Lawrence Summers, Deputy Under Secretary for International Affairs at the US Treasury, had expressed his view at the Bretton Woods Commission's annual meeting on 21 July 1994 that any further weakening of the dollar would be detrimental to global economic recovery (the President of the Deutsche Bundesbank, Hans Tietmeyer, had previously also indicated a preference for a stronger dollar), the exchange rate rose more than 2 per cent (from 1.5560 DM/$ to 1.5925 DM/$) in a matter of minutes.

8 The Bretton Woods Commission under Paul Volcker's chairmanship has also advocated a move toward a target-zone concept in the long term in order to stabilize exchange rates (following an introductory phase of greater harmonization) ("Report of the Bretton Woods Commission," unpublished manuscript, 6 June 1994, p. 5.

9 John Williamson, one of the mentors of the target-zone concept, again appealed for the introduction of the concept, together with C.Randall Henning, at a recent Washington conference (Cf. Williamson, J. and Randall Henning, C. (1994) "Managing the monetary system," paper presented to a Conference on Managing the World Economy of the Future held by the Institute for International Economics

in Washington, 19–21 May.)

10 Cf. ibid., p. 28.

11 Bergsten, C.F. (1994) "Managing the world economy for the next half century," paper presented to a Conference on Managing the World Economy of the Future held by the Institute for International Economics in Washington, 19–21 May, p. 18. His arguments are fundamentally opposed by Horst Schulmann in the same volume.

12 Tobin proposes that all foreign exchange transactions, including non-speculative ones such as trade transactions and long-term capital movements, should be subject to a foreign exchange turnover tax. The idea is to raise the transaction costs facing short-term capital movements of a speculative nature. (See Tobin, J. (1978) "A proposal for international monetary reform," *Eastern Economic Journal* 4:153–9.) Europeans are extremely reluctant to bet on such a formula, since they are collecting bitter lessons from the futility of harmonizing the bare essentials for a withholding tax on interest payments, let alone eliminating tax-free havens.

13 McKinnon, R. (1982) "Currency substitution and instability in the world dollar market," *American Economic Review* 72:320–33; McKinnon, R. (1984) "An international standard for monetary stabilization, policy analysis," *International Economics* 8: Washington DC.

14 Bofinger, P. and Gerberding, C. (1988) "EMS: a model for a world monetary order?," *Intereconomics* 23 (5): 212–19.

15 This is also borne out by the frequent revisions made to national convergence programs during Stage 2 of European Economic and Monetary Union which has been in progress since 1 January 1994; these have not exactly been helpful to the credibility of national stability programs.

16 The point was made by Lloyd Bentsen to the Bretton Woods Commission on 21 July 1994. He also proposed that the IMF ought to function as a worldwide early-warning system for economic dangers on the horizon.

17 Successful examples of this approach are provided by the Netherlands and Austria, which opted to join in the Bundesbank's hard-currency policy by establishing deutschmark exchange rate targets. For more than ten years, the Dutch guilder has remained within the EMS's narrow band; after the EMS band widths had been dramatically widened, the Netherlands and Germany entered into a bilateral agreement to maintain a fluctuation range of +/–2.25 per cent for their respective currencies. In the case of the Austrian schilling, the exchange rate has remained essentially unchanged for twenty years, even though no formal agreement has been made to that effect.

18 Duisenberg, W. (1994) "Yendollarmark," *Die Woche,* July 21.

19 Since the beginnings of the process in the 1950s, the wish for integration in Europe has been guided by a desire to bind the two rival Continental nations of France and Germany so closely together that any military conflict between them would be banished to the past once and for all. In this respect, European integration has been a tremendous success story. The associated political stability and the willingness to be conciliatory were, on the one hand, preconditions for economic integration in practice. On the other hand, it was the prospect of the gains to be made from a more intensive division of labor that facilitated a willingness to enter into closer political relations.

20 Professor Szász examines issues involved in progressing toward a single European currency (paper prepared by Professor André Szász, an Executive Director of the Netherlands Bank, for the SUERF colloquium on "The new Europe; evolving economic and financial systems in East and West," in Berlin on 8–10 October

1992. Reprinted in *Bank for International Settlements Review* 149, see esp. p. 4.

21 Duisenberg, W (1994) "Die Rolle der Zentralbanken in einer sich wandelnden Welt," paper presented to a conference staged by the Institut für Bankwirtschaft und Bankrecht in Cologne on 29 June.

22 Lamfalussy, A. (President of the European Monetary Institute) (1994) "Central Banking in Transition," 1994 Per Jacobsson Lecture, London, 8 June. Reprinted in Deutsche Bundesbank *Auszüge aus Presseartikeln* (Press Review) 43, 20 June.

23 VWD-Mitteilungen, 21 July 1994 reporting remarks made by C. Fred Bergsten at the meeting of the Bretton Woods Commission on 21 July 1994 in Washington.

24 See Jochimsen, R. (1992) "European economic and monetary union," speech at the Sixteenth European Regional Meeting of the Trilateral Commission, Dublin, 23 October. Reprinted in Deutsche Bundesbank, *Auszüge aus Presseartikel* 79, 10 November.

25 NAFTA: North American Free Trade Agreement; ASEAN: Association of South Asian Nations; MERCOSUR: Mercado Comun del Sur (the common market in the southern countries of Latin America).

26 For a start, the processes of integration policies, which are motivated by a wide variety of economic, security policy and politico-economic factors, will be enriched by a further significant element. A successful regional stabilization of relative currency movements is likely to strengthen infra-regional trade, productive and investment interrelationships, thus at least partly reducing the susceptibility to shocks arising outside the bloc boundaries.

27 This is all the more true in so far as harmonization entails the need for countries to be willing to renounce certain powers and to enter into compromises in important areas of economic policy. This would appear to be more readily achievable at a regional level, where the individual benefits to a participating country will be more clearly obvious, than on a worldwide basis. On a world scale, the benefits of economic cooperation assume the character of a public good, so a regional solution, with the more transparent potential conflicts and interests found in a smaller group, holds a greater promise of success. On the relationship between a group's size and its efficiency, see Olson, M (1965) *The Logic of Collective Action,* Harvard.

28 Thus, in contrast to the global level, the temptation to adopt a free-rider position is less likely to arise in a regional context involving more deeply integrated economies, in which the necessity for a country to adopt a certain position is more clearly recognizable.

29 In the EMS, in particular, it was repeatedly apparent that the partner currencies were responding asymmetrically to disruptive impulses originating outside the bloc's boundaries. Yet, even so, the exchange rate mechanism proved remarkably stable.

30 Quite apart from the danger of protectionist tendencies and a "fortress" mentality in the tripolar groupings, there is the additional risk that the Third World countries will be excluded, especially the continent of Africa. On this complex of problems, see also Oman, C. (1994) *Globalisation and Regionalisation: The Challenge for Developing Countries,* Paris: OECD Development Centre Studies.

31 Gyohten, T. (1992) "Regionalism in a converging world," *The Trilateral Commission Working Group on Economic Interdependence Issues,* March: 2.

32 See Jochimsen, R. (1993) "European economic and monetary union—the do's and don't's; *The World Today* 6 (June): p. 115.

33 Especially in 1977, a number of exchange rate realignments were needed. France had to leave the system in 1974 and then again for a longer period in 1976; Sweden and Norway terminated their associate membership in the two following

years, thus leaving a five-member bloc in 1978 which did not include major Community member states such as France, the United Kingdom and Italy.

34 Bofinger, P. and Gerberding, C. (1988) "EMS: a model for a world monetary order?", *Intereconomics* 23 (5).

35 The only exception was a 3.8 per cent devaluation of the Italian lira on 8 January 1990.

36 On this, cf. Jochimsen, R. (1994) *Perspektiven der Europäischen Wirtschafts— und Währungsunion,* Cologne, p. 39.

5

GLOBAL ECONOMIC INTEGRATION AFTER THE COLD WAR

How will the economic order created at Bretton Woods adjust to three billion new members?

David D.Hale

DEFINING THE CHALLENGE OF GLOBAL ECONOMIC INTEGRATION

As 1994 was the fiftieth anniversary of the Bretton Woods Conference, there has been an upsurge of discussion during recent months about whether new global economic summits should be convened in order to examine the challenge facing the post Cold War international order. The financial media have carried numerous articles questioning the future role of the institutions created at Bretton Woods as well as how the international economic system will absorb the re-entry of three billion people who had previously excluded themselves from the global marketplace for goods and capital because of Marxist or mercantilist economic policies. Should the major industrial nations attempt to re-create exchange rate target zones in order to lessen currency volatility? Should the mission statements of the World Bank and the IMF be redefined in order to focus their efforts on the world's poorest countries even more explicitly than is already happening? Will the new World Trade Organization be able to mediate trade disputes more effectively than the GATT system which was created after 1947 without such an institution? Does the former Soviet Union need a new Marshall Plan in order to achieve currency stabilization and establish credible institutions for promoting its transition to a market economy? Will the emergence of a more multi-polar global economic system encourage increased economic nationalism or will the rapid growth now occurring in global trade and capital flows erode the role of the nation-state as the dominant organizational unit in the international system?

As the Cold War ended with the moral and physical exhaustion of the communist system, rather than military hostilities and an official surrender, there will never be a formal successor to the Bretton Woods Conference. Instead, the evolution of the new world order will be addressed through a variety of ad hoc institutional changes resulting from G7 summits, the implementation of the new GATT treaty, regional free-trade agreements and private-sector initiatives. While such ad hocery will not produce proposals for systemic reform as bold and far-reaching as those offered at Bretton Woods, it also will not represent as great a departure from the actual evolution of the Bretton Woods system as pundits often suggest. According to Professor Barry Eichengreen, the Bretton Woods system was successful in launching the postwar economic recovery because it provided "an appropriate combination of rigidity and flexibility." It established a framework of rules to guide the re-establishment of currency convertibility and liberalization of trade. But the new system was also flexible in coping with foreign exchange shortages and tensions over trade policy through other innovations such as the Marshall Plan, the European Payments Union and the replacement of the failed International Trade Organization with GATT.

Establishing effective institutions and rules for the post Cold War international order will also require a combination of rigidity and flexibility but, because of the peaceful way in which the Cold War ended and the tremendous changes which have occurred in the composition of world output since 1944, the process of international economic decision-making and the sequencing of policy reform in the post Cold War era will follow a very different course than the early Bretton Woods years. Governments will play an important but far less decisive role in shaping the contours of the new global economic order than during the Bretton Woods era, while the private sector will play a far more dominant role.

The Bretton Woods conference focused on how to finance postwar reconstruction and establish rules for a stable world economic order after the three decades of political disintegration resulting from two global military conflicts and the Great Depression. The dominant policy challenges of the mid-1990s will be to re-absorb three billion people who had previously been living under Marxist or mercantilist economic systems back into an already well-functioning global marketplace for goods and capital. The arrival of so many new players may eventually force the international system to create major new institutions and introduce new systems of rulemaking, but during the next few years the major emphasis will be on integrating the new players into existing structures.

In addressing the reintegration challenge, policy-makers will enjoy advantages and confront obstacles quite different from those which prevailed at Bretton Woods in 1944. Their first advantage will be that we have inherited far stronger international rules and institutions to serve as a launching pad for the new world order than existed before the 1944 Bretton Woods Conference. When the Cold War ended there was already a new round of

GATT negotiations under way which encompassed over 140 countries, including, for the first time, many developing countries. The new GATT treaty will also establish a World Trade Organization, whereas the proposals for one which emerged in the aftermath of Bretton Woods were rejected by the US Congress. The World Bank and IMF, which were established to help finance postwar reconstruction and manage the exchange rate system, have evolved also into de facto development banks and economic counselling agencies for low and middle-income countries which have liquidity problems or which are unable to attract long-term capital because they have yet to develop effective security markets. In 1944 there were no multilateral development agencies, while many of the current clients of the IMF and the World Bank were European colonies.

The second advantage which policy-makers enjoy over those prevailing in 1944 is that the world has highly developed security markets with large pools of both short-term and long-term capital. During the past decade there has also been far more dramatic growth of international capital flows via security markets than at any time since the late nineteenth century. In recent years, many developing countries have participated in this securitization boom by establishing bond and equity markets, whereas during most of the modern period they had depended primarily upon official aid or bank lending. In 1993, for example, the so-called emerging market economies were able to attract over $110 billion of private foreign capital through a mixture of security purchases and direct investment. In the first decade after Bretton Woods, by contrast, many industrial countries had limited currency convertibility and were heavily dependent upon official lending assistance from the United States. Between 1947 and 1953, for example, the Marshall Plan provided Europe with financial assistance equal to 2.5 per cent of GDP, while the IMF loaned over $750 million to a wide range of countries. As the war had ravaged the economies of Western Europe and created great uncertainty about the political future of some countries, the Marshall Plan did not help merely to finance the rebuilding of damaged infrastructure; it also helped to set the stage for a private-sector investment recovery by restoring confidence among Germans, Italians and the French that their countries would remain part of the free world.

The final great advantage which policy-makers enjoy today compared to those of the Bretton Woods era is the instructive experience of East Asia's economic take-off as a model for economic development elsewhere. In 1944, Russia was under communist rule, Britain was about to elect a socialist government committed to large-scale nationalization of private enterprises, and the policy elites of many soon to be independent developing countries were attracted to economic development models which promoted state control and import substitution. Today, there is a broad intellectual acceptance that the private marketplace allocates resources more effectively than politicians and that governments should concentrate on the delivery of public goods (law and order, environmental protection, unemployment compensation) which the private sector cannot provide by itself.

The obstacles to effective international economic cooperation in the post Cold War world order reflect both the successes and the failure of the Bretton Woods system. First, there are now over 200 independent countries on the planet compared to several dozen after the Second World War. It will be far more difficult to achieve consensus on policy issues among such a diverse group of states than was the case when a few industrial countries in the North Atlantic ruled three-quarters of the world and accounted for over 80 per cent of its output. In fact, the Bretton Woods Conference was largely a debate between the USA and the British Empire. Second, the USA is no longer able or willing to play the role of an economic superpower providing international public goods, such as the Marshall Plan, to other players for free. The USA is still the world economy's largest national entity on the basis of nominal income but its share of world output has returned to the levels which prevailed before the outbreak of the Second World War. As a result of the wartime damage inflicted on the continent of Europe and Japan, the US share of world output in 1944 exceeded 50 per cent, while the British Empire accounted for another 10–15 per cent. The world economy today is far more multi-polar. According to recently revised World Bank estimates of global real GDP, the USA now accounts for about 23 per cent of world output, Western Europe for about 18.5 per cent, Japan for about 8.0 per cent and the developing countries, including the former Soviet Empire, for about 45 per cent. The USA is still the world's largest economic power but it can no longer dominate decisionmaking in the same way that it did forty years ago nor is it as prepared to act unilaterally in assuming expensive obligations when multilateral institutions are incapable of solving problems. The end of the Cold War has also caused the USA to adopt a more narrow and mercantilist definition of its economic self-interests than was the case when security interests dominated foreign policy and American industry was more confident of its competitive position. Finally, there is no clear replacement for American leadership, either in terms of alternative powers or collective decisionmaking structures. In fact, the erosion of US power, coupled with the end of the Cold War, means the Western Alliance has lost both a unifying issue (the struggle against communism) and the traditional American capacity to force action in the absence of an intellectual consensus.

It could be argued that the diminished role of the USA is less of a problem than it might appear at first glance because the triumph of marketbased economic systems will encourage countries to support liberal trade and investment policies without the American coercion or incentives for good behaviour which were necessary in the past. In 1944, the world needed an American superpower to promote free trade, provide financial aid to war-ravaged Europe and organise a military alliance against the Soviet Union, because there was no one else capable of playing such a role. In 1994, practically all countries understand the benefit of liberal economic policies, the private sector is poised to finance an infrastructure boom in those developing countries willing to privatize such activities through stock markets, and the Soviet Union has ceased to be a hostile military superpower. The countries of the former Soviet Union will probably require some form of externally supported financial stabilization program in order to establish currency convertibility and create credible institutions for guiding the transition to a market-based economic system, but the barrier to completing this task is not a shortage of foreign financial assistance. The major barrier is political disagreements within Russia and the other former Soviet states themselves about how to manage the social consequences of privatizing state enterprises and shrinking those which are unsaleable. In fact, Russians have probably exported over $40 billion of flight capital since 1990 or a sum in excess of the Marshall Plan as a share of Europe's GDP in the late 1940s.

The irony of the post Cold War era is that the role of the USA has been diminished by the economic success of other countries after they embraced many of ideas which the USA itself advocated at Bretton Woods. It is true that some countries, such as Japan and Korea, have developed different forms of capitalism in terms of corporate ownership structure and the role of government as a catalyst for change, but the dominant factor in their success has been encouraging a high level of private savings and investment as well as allocating resources on the basis of world prices. In contrast to the former Soviet bloc, India and some Latin American countries, the role of government in corporatist East Asia has been prescriptive rather than proscriptive.

The new, multi-polar structure of the world economy suggests that the international system will develop a multi-tier approach to cooperation. Governments are already achieving a fair amount of success in pursuing agreements on a variety of microeconomic issues, such as regulating foreign trade and investment. They will probably also achieve new progress in developing agreements on environmental protection and immigration control. There is not yet an intellectual consensus about how to approach either issue but there is no doubt that both will become progressively more important during the next century. As the World Bank projects that practically all of the growth in the world labor supply during the next quarter century will occur in the developing countries while the population of Japan and many European countries is projected to shrink, there will either be increased emigration to the old industrial countries or they will have to shift more labor-intensive output to the developing countries. There will also have to be new international agreements to protect the environment, because the coming boom in world output will produce a large increase in the emissions of carbon as well as other potential pollutants. On the basis of current trends, for example, China's carbon emissions could overtake those of the USA by the year 2025. What remains unclear is whether the major countries in the system will attempt to deal with such problems through price changes (high energy taxes) or direct controls on consumption. The USA has long resisted big increases in energy taxes, but the alternative solutions could ultimately prove to be even more unpalatable.

While it is possible to construct scenarios for international cooperation on a variety of microeconomic issues, it is far more difficult to imagine similar agreements on some of the systemic macroeconomic issues, such as the restoration of a fixed exchange rate system or the creation of new financial institutions to expand global liquidity, which dominated the Bretton Woods Conference. The G7 countries have pursued an ad hoc strategy of exchange rate management since the extraordinary dollar overvaluation which occurred during the early Reagan years, but it has been successful primarily because there have been no new economic policy shocks in the USA. On the contrary, the Clinton administration has pursued a very orthodox fiscal policy. The currency disequilibria of the early 1990s centered on the deutschmark and its relationship to other European currencies. As with the USA during the Reagan years, Germany needed a deutschmark realignment after 1990 in order to help the economy adjust to the large government deficits produced by unification. It needed to shift resources from tradeable goods to domestic public investment and to switch from being a large-scale capital exporter to being a modest net capital importer. But other European countries had invested so much political credibility in the creation of an inflexible exchange rate system that the deutschmark remained fixed, until the severity of the resulting recession in other European countries forced them to accept wider target bands. In a well-functioning system, the deutschmark would have been revalued as soon as it became clear that the German public-sector deficit would rise to 6.0–7.0 per cent of GDP and that the Bundesbank would resist inflationary expansion of the money supply.

The ERM crisis has caused many analysts to suggest that it will be difficult, if not impossible, to re-establish a managed exchange rate system, but such comments are a misinterpretation of the European crisis. The fact is there was a clear and compelling economic case for the deutschmark to be realigned but it was resisted for a variety of political reasons, especially French ambitions to promote the creation of a European central bank as an instrument for limiting future German policy autonomy. The real barrier to restoring explicit exchange rate target zones in the 1990s is the extraordinary growth now occurring in private-sector capital flows between national financial centers.

In 1993 and the first of 1994, for example, the USA emerged as the world's largest capital exporter because of both retail investors fleeing, low short-term interest rates and the decision by the US pension funds to embark upon a large-scale multi-year global portfolio diversification program. As the USA already had a large current account deficit, the $130 billion of private capital outflows to purchase foreign securities caused the dollar to fall sharply, despite large reductions in the federal deficit and a 200-basis-point hike in US short-term interest rates. The Bank of Japan engaged in large-scale currency intervention in an attempt to stabilize the yen, but the intervention was of limited effectiveness because of the magnitude of Japan's current account surplus and the cautiousness of Japanese investors towards foreign security purchases. As Japanese investors have lost over $320 billion on their American investments during the period 1986–93, they were far less anxious to recycle their country's large trade surplus into US financial assets during 1993 and the first half of 1994 than they were during the 1980s.

In the 1970s and 1980s, it was possible to attribute exchange rate movements to policy shocks (high inflation, large budget deficits, etc.) but during the past two years they have often reflected investor perceptions of relative value in global bond and stock markets as well as structural changes in the fund management industry itself. In the USA, for example, the pension fund sector is now significantly increasing its weighting for foreign securities. It may boost the weightings to 10–15 per cent by the year 2000 from only 5 per cent a few years ago. Such diversification could produce capital outflows of $400–500 billion during the next few years, despite the fact that the USA has a current account deficit and thus needs to import capital. American investors also have developed a large new appetite for foreign equities and bonds through both direct purchases and mutual funds. In 1993, for example, they purchased over $50 billion of international mutual funds compared with numbers of less than $1 billion per annum during the 1980s. In fact, the USA now has several hundred international mutual funds, compared to less than five in 1982. Many other countries are also experiencing the same diversification phenomena because of the large drop in the cost of international portfolio investment resulting from new developments in computer and communications technology. Ironically, Japan is the only country in which foreign investment has recently declined from the levels of the 1980s, but this slowdown will ultimately self-correct in either a smaller trade surplus through further yen appreciation or new interest rate cuts and a rally in Japanese asset prices which would encourage a revival of capital outflows.

As we are in the early stages of an unprecedented global portfolio diversification program among both the institutional and retail investors of the old industrial countries, the G7 governments would have had to accept a flexible approach to exchange rate management during the mid1990s even if they had agreed to convene a new Bretton Woods Conference. Nor would exchange rates have been the only issue on which they would have had to diverge from the rules of 1944 in order to accommodate the rebirth of highly integrated global financial markets.

If a new Bretton Woods Conference had been convened to address the development of the post-Cold-War economy, governments would have had to accept a whole new set of paradigms about the relative roles of the public and private sectors in the global restructuring process. As the Cold War ended without military hostilities or the traditional surge of inflation which accompanies military conflicts, it has left the private sector of the G7 countries far richer in relative terms than it was in 1944, whereas many governments are nearly as indebted today as they were after the Second World War on the basis of existing debt/GDP ratios and future entidement claims on their tax revenues.

At the end of the Second World War, the ratio of US government debt to GDP was about 125 per cent, while Britain's was close to 200 per cent. Most continental European countries, by contrast, had extinguished their public debt through hyper inflation. In 1994, the USA and the UK have public debt to GDP ratios of 50–60 per cent, but many other industrial countries (Italy, Canada, Belgium, Sweden, Greece) have debt/GDP ratios in the 100–200 per cent range, while in the OECD as a whole public debt has increased from 40 per cent of GNP in the late 1970s to 73 per cent currently. The governments of the industrial countries also have massive unfunded liabilities worth two or three times their national income for state pension programs and health care systems which simply did not exist in 1944. Finally, government debt-servicing costs have increased significantly because investors are demanding large risk premiums to compensate for the danger of large government deficits, and this encourages a resurgence of inflation or even a future default. While the fiscal poverty of the public sector has not been put forward as a reason for avoiding large official resource transfers to the emerging market economies, it is clearly a constraint on many governments' freedom of action.

The private sector in the industrial countries, by contrast, has accumulated significant wealth during the past five decades and has concentrated much of it in tax-sheltered savings institutions (pension funds, insurance companies, etc.) which are now equipping themselves to invest on a global scale. This remarkable combination of G7 public-sector indebtedness and private-sector affluence is rapidly creating a global financial marketplace which has far more in commn with the world before 1914 than any intervening decade. As in the late nineteenth century, the dominant players in this new marketplace will be private investors, commercial bankers and multinational corporations, not governments or official aid agencies. In fact, the transformation in the role of the private sector as a supplier of capital to the developing countries has already been dramatic. During the 1990s, more than fifty developing countries have established domestic capital markets in order to encourage the privitization of public enterprises and attract greater foreign investment. Their combined stock market capitalization is now $2.1 trillion, compared with less than $400 billion in the late 1980s. The private capital flows to them from the industrial countries reached $110 billion last year and will expand further as the world economy recovers. It would not have been possible for the private sector to undertake such large-scale capital transfers if G7 governments had not eliminated official exchange controls during the 1970s and 1980s, but the fact remains that private investors are acting on their own initiative, not in response to government pressure. Even in the late nineteenth century golden age of global capitalism, the governments of France and Germany intervened far more aggressively to guide private capital outflows than they would dare to do today.

As a result of the greater role which the private sector will play in designing the structure of the post Cold War world economy, it will have several contrasting features with the Bretton Woods era. First, the large flow of capital between countries will cause governments to remain cautious about returning to fixed exchange rates. Many developing countries will use exchange rate targets during the initial stages of price stabilization programs, such as Argentina and Mexico after 1990, but they will probably shift to more flexible systems when their central banks enjoy sufficient credibility to establish targets for inflation themselves. As the global investment boom of the late nineteenth century coincided with the fixed exchange rate system produced by the gold standard, there is no theoretical reason why a G7-managed exchange rate system could not coexist with greater capital mobility, but such a system would require far more domestic price flexibility than appears to be possible under current circumstances. In the gold standard era, for example, wholesale prices fell by almost 40 per cent between 1869 and 1900, forcing interest groups in commodity-producing countries such as the USA to accept much larger income losses than would be acceptable today. Today, most developing countries would respond to such a large price shock by devaluing their currencies.

Second, competition for capital will encourage countries to accelerate economic reforms designed to attract foreign investment or bring home the flight capital of their own citizens. The introduction of such reforms should boost output growth by encouraging far more efficient resource allocation in regions such as Latin America, Africa or India than was possible under the statist economic policies which prevailed before 1989. As with Korea and Taiwan after 1970, many more countries should therefore be able to double their real per capita incomes every ten years, whereas it took the USA and Britain nearly half a century to do the same after their industrial revolutions began.

Third, the greatly improved ability of many developing countries to import private capital will encourage the Bretton Woods lending institutions, especially the World Bank and the IMF, to focus more of their efforts on troubled countries which are unable to attract private funds because of recurring failures in economic policy, chronic political instability or natural disasters. It is true that the World Bank has recently helped to encourage implementation of economic policy and the growth of private capital flows through agencies such as the IFC, but this role will quickly fade in countries which create effective banking and fund management groups in the private sector. The World Bank may also play a greater role promoting the development of human service agencies (health care, education) and protecting the environment in low—and middle-income countries which are able to finance the development of their manufacturing and commercial enterprise with private domestic or foreign capital.

Fourth, the market-oriented economic reforms now occurring in lowsavings developing regions, such as Latin America and Africa, should help to boost their savings rates towards the high levels which have long existed in many East Asian countries. But the reform process is also producing so many new investment opportunities that they are likely to generate a greater demand for foreign capital as well. In fact, the large savings surpluses which some East Asian countries (Taiwan, Thailand, Indonesia) enjoyed during the 1980s have also fallen sharply because their investment rates have climbed to much higher levels, while affluence has encouraged their household sectors to borrow on a larger scale than before. This new demand for funds will intensify the global competition for capital at a time when the US private savings rate is at low levels and Europe is struggling to restrain bond yields in the face of large public-sector budget deficits. As a result, policymakers will have to focus far more attention on the adequacy of global savings to finance both cyclical economic recovery in the old industrial countries and the new investment needs of the emerging market economies. In the Bretton Woods era, by contrast, policy-makers were far more concerned about promoting Keynesian-style demand management policies and stabilizing employment. There is also a risk that some countries may attempt to link access to their capital markets to trade preferences. In the nineteenth century, France and Germany often tried to ration their foreign lending on the basis of political relationships and trade advantages, whereas the London market was far more open. Many countries now use official export banks to bolster the competitive position of their capital goods industries, but there are international agreements which limit how far countries can go in using such credits to subsidize exports. If capital access becomes a more important factor in the competition for global export markets the major beneficiary will probably be Japan, simply because it has far more excess savings than the older industrial countries.

Finally, the rise of potentially large and dynamic new economies in Asia, Latin America and the former Soviet bloc will create new trade tensions with the old industrial countries. Just as the USA and Europe found it difficult to accept the rise of Japan as a major economic power, so there is likely to be anxiety about the emergence of China, India, Brazil, Mexico or Korea as industrial competitors. The coming rise in output from these lowcost producers will intensify the downward pressure already apparent, because of technological change, on the wages of unskilled workers in the old industrial countries, while their capital needs will boost the level of world real interest rates. In order to resist popular demands for more protectionist trade policies, the industrial countries will have to devise more effective strategies for helping unskilled workers enhance their productivity and move to higher-value-added jobs. Canada and Western Europe already have well-developed social safety nets (some claim they are a barrier to labor mobility) but, as was apparent from the strong American trade union opposition to NAFTA, the USA spends far less on worker retraining and labor adjustment programs than other industrial countries.

What remains to be seen is whether the process of global economic integration through rapid growth of private trade and investment will help to encourage greater transnational cooperation in problem solving or whether political systems will react against the integration process because of the threats which it may pose to their perceived autonomy. Some prominent historians, such as Professor Samuel Huntington of Harvard University, contend that, despite the unprecedented scope of the economic integration now occurring between countries, the end of the Cold War will produce new political divisions based on culture and ethnicity rather than ideology. A few political events since the end of the Cold War, such as the Bosnian civil war between Serbs and Moslems, support the Huntington thesis but other political changes, such as South Africa's peaceful transition to majority rule, illustrate how opportunities for economic advancement through expanded foreign trade and investment can also help to encourage democratic reform. The South African white community concluded that apartheid had become counter-productive to its prosperity because it was denying it access to foreign capital and trade while creating a progressively larger underclass of militant blacks. The white community accepted a peaceful transition to majority rule in the hope that the new ANC government would pursue outward-looking, market-oriented economic policies capable of bolstering the real incomes of all South Africans, not just particular racial groups. In the ideological climate which prevailed during the Cold War, it would have been unthinkable for South African whites to surrender domestic political power in return for improved access to the world marketplace for goods and capital, while it would have been inconceivable for the ANC to commit itself to the preservation of capitalism, or to accept GATT and other forms of market-driven economic development. Yet with the passing of the Cold War, both sides decided that they could enhance their own prosperity by attempting to work together. They still face formidable obstacles, which could trigger renewed violence, but the progress they have achieved is nevertheless extraordinary in view of the historical circumstances.

The history of Europe during the twentieth century proves that economic integration, alone, cannot totally eliminate the risk of ethnic conflict. In the half century before the First World War, Europe had achieved a high level of economic and financial integration but it was still unable to prevent competing nationalisms in Central Europe from dragging the major powers into a devastating war followed by an unstable peace and second great war. If early twentieth century Europeans could not suppress their ethnic rivalries despite the rapid growth of trade and investment occurring between them, how will the Americans, the Chinese, the Indians, the Japanese, the Russians, the Germans and the Africans be able to set aside historical animosities and distrust to co-exist peacefully?

The answer is that there are no guarantees that rapid economic growth and market-driven global economic integration will produce a more harmonious global political order than did the economic integration which occurred before the First World War. The pessimists have several factors on their side.

First, the economic boom now occurring in the developing countries will provide a variety of hitherto high-population but low-income countries with far more resources to purchase expensive new weapons systems than they have ever had before. As many countries have not reduced their defense share of GDP despite rapidly rising incomes, there is a risk that at some point they might be tempted to use the weapons as a foreign policy tool.

Second, the process of industrialization itself will force hundreds of millions of Chinese, Indians and Africans to move from the countryside into sprawling, overcrowded urban centers. Such a large-scale uprooting of people from traditional societies will erode existing systems of political and social control, creating potential new conflicts which some leaders might attempt to resolve through more aggressive foreign policies.

Third, the international economic system will continue to depend heavily upon the Persian Gulf states for oil supplies during the next quarter century. With oil demand rising rapidly in the new high-growth economies of East Asia and Latin America, it is not difficult to construct scenarios in which oil prices could rise back into the $25–30 per barrel range by the late 1990s. But the price hikes could be much larger if the Islamic fundamentalist movement disrupts oil production in Algeria and Egypt or if Iraq and Iran intimidate their neighbors into accepting large production cuts in order to force prices higher.

Fourth, the countries of Southeast Asia have such large Chinese populations that it is possible to imagine them re-establishing commercial links with their mother country and creating an informal "Confucian commonwealth" in the region, which would be highly self-sufficient in savings (East Asia's savings rate is 50 per cent higher than that of the USA) and increasingly geared to promoting trade within the region, especially if North America and Europe turn more protectionist. The countries which a cultural determinist would identify as greater China (the PRC, Taiwan, Hong Kong and Singapore) already have over $200 billion of the world's foreign exchange reserves or a sum which correlates with their 20 per cent share of world population. The surplus savings of the overseas Chinese coupled with the vast supplies of low-cost labor in China itself have the potential to create a powerful new economic entity in East Asia which is far less dependent upon the USA and Europe than the other high-growth Asian economies which emerged during the 1970s and 1980s.

The problem with the Huntington thesis is that the process of economic development will require ultimately far more transnational convergence in political institutions and social values than has ever occurred before. In order to achieve a sustained economic take-off a country has to give its citizens a reasonable amount of freedom to pursue their own self-interest within a civic framework of rights and responsibilities which includes the rule of law, a fair judiciary and some form of accountability for government officiais. In both Europe and Asia, people usually obtained economic rights before they received political freedom, but the timing gap has been so great that Europeans and Americans often forget how the process occurred. After the great plagues of the Middle Ages there was a scarcity of labor, which forced lords of the manor to compete for workers by offering more economic rights to their serfs. Medieval kings also tried to obtain cash from merchants by granting them trade concessions or relaxing restrictions on commercial activities.

The countries of East Asia, driven by economic modernization, are now embarking upon a similar evolutionary path. Rapid industrialization is increasing the demand for labor, boosting the standard of living and gradually encouraging people to demand more accountability from their political leaders. As Korea and Taiwan have recently demonstrated, the population may initially have to express its aspirations for more political rights through strikes and violent demonstrations, but so far the authorities have been compelled to accommodate their desires. The communist system attempted to break the link between economic modernization and freedom but it failed ultimately because a high-technology society, with its proliferation of new information-sharing systems, is simply incompatible with a totalitarian form of political control.

In the Huntington model, the two great alternatives to Western culture are the Confucian world and the Islamic world. Both, clearly, have very different historical experiences and religious traditions from those of Europe and North America. Yet it is very dangerous to generalize about countries and people in both cultural groups on the basis of broad labels, such as Islamic or Confucian. In the Islamic world, there are now several countries, including Indonesia, Malaysia, Pakistan, Bangladesh, Turkey, Jordan, Egypt, Tunisia, and Morocco, that are attempting to attract foreign investment and promote trade with the West. They are having varying degrees of success, but there is no doubt about the overall thrust of their ambitions. Turkey would even like to join the European community. As these countries account for almost one half of the world's one billion Moslems, no one can say that religious fundamentalism is the only strong intellectual current in the Islamic world today. It is flourishing primarily in countries where economic performance has been undermined by socialist systems introduced at the time of independence. The overseas Chinese community also has very ambiguous feelings about its relationship with China and the West. While the overseas Chinese are intrigued by China's economic potential and are often dismayed by the social permissiveness of North Americans and Europeans, they have learned from personal experience that successful economic development requires the introduction of Western institutions such as rule of law, private property and accountable government. Moreover, the importance of these factors will become even more apparent when Hong Kong completes its coming transition to Chinese rule. If China does not protect the British legacy of judicial independence in the legal system it will ultimately undermine the economic performance of the territory, despite Beijing's intention of using it as a model for how it would treat Taiwan.

In addition to the economic pressure for institutional convergence as countries attempt to become players in the global marketplace, the spread of technology and declining cost of transportation is creating far more opportunities for the current and future elites of nations from different cultural traditions to intermingle on a personal basis. A large share of the technocrats now guiding the economic reform programs of Latin America, Asia and Africa trained at universities in the USA or Europe. American and European multinational corporations are also increasingly employing large numbers of foreign nationals in senior managerial positions, not just in shop floor jobs. There are also a growing number of multinational firms in several developing countries, including Singapore, Hong Kong, Taiwan, Korea and Mexico. The rise of the multinational corporation has no real precedent in earlier periods of global economic integration. In the nineteenth century, for example, most foreign investment occurred through security markets or the emigration of Europeans to new regions of settlement. There were colonial trading companies but they did not produce mutli-ethnic managerial structures akin to modern corporations. In some cases, they ruled whole countries (Rhodesia, India) and employed armies to control the local populations.

As a result of the political and social transformations which accompany economic take-off, the Huntington thesis is likely to prove accurate only if the process of global economic integration is itself punctured by a financial shock, an upsurge of protectionism in the old industrial countries or some other calamity which plunges the world into a severe slump. As in Central Europe during the interwar years, resentment at economic failure might then spawn new political movements which play upon ethnic nationalism, but the dominant factor pushing popular sentiment in such a direction will be falling real income, mass unemployment or hyperinflation, not a cultural clash between civilizations.

The ideological struggle between capitalism and communism has ended, but the political stability of many important countries in the developing world is still far from assured; they are in the early stages of a political transition which occurred in the West when people were far less selfconscious about the social contradictions of rapid economic change. As in the nineteenth century, the private sector is likely to dominate the next wave of global economic development far more than it did during much of the twentieth century. But the ultimate duration and breadth of the boom now getting under way will depend upon how effectively governments manage the social and economic side-effects of the price shocks coming to real wages and interest rates, as well as the externalities which the boom will generate for the environment, migration patterns and the diffusion of military technology. If governments simply maintain free trade policies and do not restrict capital mobility the private sector will soon create an international economic order with a higher level of financial and commercial integration than existed before 1914. But the challenge facing policymakers is not merely to return to the world of 1914. It is rather to strengthen the multilateral institutions and domestic safety-nets underpinning the process of global economic integration in order to insure that it retains sufficient momentum to overcome the surprise fluctuations of the business cycle, upsurges of ethnic nationalism on the periphery and other shocks which still have the potential to produce a world order as dark as the one which followed the Treaty of Versailles rather than the one conceived at Bretton Woods.

The remaining sections of this paper examine critical aspects of the global reintegration challenge for public policy in both the old industrial countries and the emerging market economies.

THE SECURITIZATION BOOM IN DEVELOPING COUNTRIES

There are few better proxies for the potential growth opportunities created by the end of the Cold War and the liberal intellectual revolution in the Third World than the explosive growth of stock market capitalization which has occurred in the developing countries since the late 1980s. This stock market boom also has opened the door to far larger private capital flows to the developing countries than at any time since the nineteenth century and is creating the potential for the most broadly based global economic upturn since the Industrial Revolution began.

Since 1987, the market capitalization of the twenty-five countries included in the International Finance Corporation's Composite emerging market index has grown from $185 billion to $1.3 trillion. There are also another two dozen emerging markets in Eastern Europe and Africa with a market capitalization now approaching $100 billion. Because of the severe slump which occurred in the Tokyo stock market after 1989, the growth rate of the stock markets in the old industrial countries since 1988 has been far more subdued. The total capitalization of the markets in the developed countries has grown from $9.6 trillion in 1988 to about $13.6 trillion last year but, excluding Japan, the growth has been more impressive. The market capitalization of the industrial countries excluding Japan has grown from $5.7 trillion to $10.6 trillion.

The IFC classifies a few Asian and African countries as developed markets, despite the fact that most investors regard them as "emerging markets." These countries are Singapore, Hong Kong, South Africa and Israel. While the per capita incomes of Hong Kong and Singapore exceed the $7,000 threshold which the IFC uses to define a country as "emerging," investors perceive them to be emerging markets because their corporate sectors are closely integrated into countries which have far lower incomes, especially China. If we add these four countries to the IFC total, the stock market capitalization of all emerging markets rises to $2.2 trillion. Some developing countries also have companies listed on foreign stock exchanges. In the case of China, for example, there are now several points of entry for international investors, including B shares worth $3.5 billion listed in Shanghai and Shenzan, H shares worth $2.3 billion listed in Hong Kong, and a few companies worth $1 billion listed in New York. In China itself, there are stock markets for local residents with an equity capitalization of over $40 billion. In addition to these newly privatized Chinese enterprises, many of the local companies listed on the Hong Kong and Taipei stock markets offer significant exposure to China through trade, manufacturing and property development. Hong Kong has a market capitalization of about $340 billion, while Taiwan has a market capitalization of about $160 billion. If we add up all of the markets which could be classified as components of Greater China their combined market capitalization is now in excess of $550 billion. This sum is not only equal to about one-quarter of all the stock market capitalization of the so-called emerging markets; it is also ten times as high as the stock market capitalization of Japan in the mid-1960s.

The expansion of stock markets in the developing countries since 1988 has been significant both in absolute terms and relative to the size of their economies. In the early 1980s, most Latin American countries had stock market capitalizations equal to only 50 per cent of GDP, whereas today they often have market capitalizations equivalent to 50–100 per cent of GDP. Before the 1990s, the only East Asian countries which had large stock markets were former British colonies (Malaysia, Singapore) and Hong Kong. Today, by contrast, there are stock markets with values approaching 100 per cent of GDP in Thailand, Taiwan, Indonesia and Korea. Although Bombay has the oldest stock market in Asia (1875), because of controls on both foreign investment and domestic savings flows, it played almost no role in the Indian economy until recently. But with India now liberalizing her economy, the Bombay stock market has re-emerged as an important vehicle for both promoting privatizations of state enterprises and attracting foreign investment.

Several factors have combined to encourage the boom in developing country stock markets. First, the collapse of communism and the spread of liberal economic ideas to many formerly mercantilist countries in the Third World have profoundly altered official attitudes towards both the role of securities markets as allocators of capital and potential vehicles for attracting foreign investment. Many developing countries had active stock markets before receiving independence during the 1950s and 1960s, but they did not encourage their growth in the modern era because of a preference for state-directed investment. In the case of many Latin American countries, stock and bond markets also suffered from hyper inflation and confiscatory tax policies. Real assets or capital flight were the only way wealthy Latin American investors could protect the value of their savings.

The second factor which encouraged the developing country stock market boom was the global banking crisis of the early 1980s. As a result of OPEC-driven balance of payments recycling, there was a boomlet in bank lending to the developing countries during the 1970s. But, because of a sharp rise in real interest rates as central banks attempted to curtail inflation, the collapse of commodity prices, and Mexico's decision to default on its bank loans, this lending came to an abrupt halt during 1981–2. The suspension of bank lending after 1982 produced a severe economic crisis in Latin America and contributed to the severity of the slump which occurred in many other countries during that period. There was not an immediate move to promote stock markets' investment as an alternative source of capital, but the debt crisis did set the stage for liberal economic reforms, which culminated in the rebirth of Latin American capital markets during the late 1980s. Except in the colonial period, the East Asian countries did not promote stock markets in order to attract foreign capital. Most of the countries in the region have high private savings rates and enjoyed far higher levels of foreign direct investment, especially from Japan, than Latin America. Their stock markets boomed during the 1980s because of the need for small family businesses to attract outside capital, the surplus liquidity created by hugh foreign trade surpluses in the region, and the sheer expansion of private wealth. In the case of Singapore and Hong

Kong, there also has been far more securitization of real estate than in other countries, and the property sector accounts for a large share of stock market capitalization in those markets.

The third factor which has encouraged the developing country stock market boom has been the general expansion of securitized forms of financial intermediation in the industrial countries since the early 1980s banking crisis. In the decades after the Second World War, commercial banks were the major repositories of households savings and engines of business credit expansion in both the industrial countries and the developing countries. But in recent years there has been a tremendous expansion of securitized forms of credit outside the banking system. In the USA, there are now large and active secondary markets for commercial paper, corporate bonds, mortgages, credit card loans and other forms of debt. The mutual fund industry, for example, has over $2 trillion of assets, or a sum equal to 85 per cent of bank deposits. The trend has not gone nearly as far in other industrial countries, because of the role of universal banks in providing both short-term and long-term finance to companies, but the growth of non-bank savings institutions, such as pension funds and life insurance companies, is still encouraging the growth of more active markets for both debt and equity.

The expansion of non-bank intermediaries and securities markets is altering profoundly the composition of capital flows in the world economy. Between 1950 and 1960, global capital flows were inhibited by the prevalence of exchange controls in both the industrial and developing countries. In the 1960s and early 1970s, there was a significant expansion of foreign direct investment as well as official lending programs to developing countries, but security markets were not important conduits for international capital transfers. After the oil price upsurge of 1973–4, there was an unprecedented expansion of international bank lending as the commercial banks recycled surplus OPEC savings to Latin America and other developing countries with a deficiency of domestic savings. During this period there was also further steady expansion of both foreign direct investment and official aid programs. In the early 1980s, international bank lending to developing countries ceased growing and, because of the large budget deficits and high private investment rate which resulted from the Reagan economic program, the USA suddenly emerged as the world's largest capital importer. As the decade progressed, there was also a significant expansion of stock-market-driven merger and acquisition activity in all of the English-speaking countries. This takeover boom attracted the attention of foreign bidders. In the late 1980s, foreign takeover bids for companies in the USA and Britain rose from practically nothing during most of the postwar period to a level equal to 1–2 per cent of GDP. The Anglo-Saxon asset markets were attractive to foreign bidders because they are relatively open compared to the markets of continental Europe or Japan, while there had been a sharp depreciation in the value of the US dollar since 1985. In many ways, the take-off of developing country stock markets has been a natural extension of the global boom in securitization. The take-off could not have occurred without the change in economic ideology in the developing countries. But the fact that the two events overlapped has vastly accelerated the speed of the transition.

THE WORLD BEFORE 1914

While many Wall Street commentators often refer to the recent boomlet in emerging equity markets as a totally new phenomena, it is actually analogous to developments which occurred in the world economy during the late nineteenth century. In the half century before 1914 there had been a tremendous expansion of capital outflows, through stock markets and bond markets, from Britain, Holland and other European countries to North America, Argentina, Australia and other so-called regions of recent settlement. During most of this period, Britain had current account surpluses equal to 8–9 per cent of GDP and recycled them through large-scale purchases of bonds to finance the construction of foreign railways, plantations and other infrastructure projects. As Herbert Feis explained in his financial history of European foreign investment during the late nineteenth century, the huge outflow of private foreign capital from England and other mature European economies was one of the most revolutionary forces in the world economy during that period.

> Before the war, in the gray and smoke-encrusted lanes and alleys close by the Bank of England, there converged the greatest free financial force in the world. The London financial market derived its strength from great wealth, diversity, experience, world connections—all directed by the sober yet daring energy. The great wealth had enlarged itself gradually through the pioneering organization of machine industry, through the conduct of commerce throughout the world, and the development of the resources of distant areas. Out of the past there came, and grew more aggravated with the course of industrial change, the marked inequality of wealth and income which bred many of the bitter antagonisms of the day. At the top of the pyramid of wealth there rested a substantial group whose great income and investing power was one of the revolutionary forces of the world. In 1914, according to the best available estimates, the annual income of the British people was the neighbourhood of 11 billions of dollars; and of this total approximately 1.8 billions were saved. These savings, available for capital expenditure of some kind, were mainly in the possession of those whose field of business and personal interests extended far beyond the British Isles.

As a result of Britain's large foreign investments, London was the world's dominant financial center before 1914. In 1910, when the total paid-up value of all negotiable securities in the world was placed at £32.6 billion, London accounted for £10.7 billion, or 32.8 per cent of the total. Meanwhile, foreign securities had grown from just over 8 per cent of the London market value in the early 1850s to 53 per cent by 1913. It is not surprising that London led the world in cross-border securities trading. Britain's total foreign portfolio and direct investment was probably worth a sum equal to 180 per cent of her GNP before 1914.

The outward surge of investment from Britain and other European countries helped to spur much faster economic growth in North America, South America, and other capital-importing nations than was occurring in the old industrial countries of Europe. Between 1870 and 1913, the US economy grew at a 4.3 per cent annual rate, the Argentine economy at a 6.4 per cent annual rate, Canada at a 4.1 per cent annual rate, and Australia at a 3.2 per cent annual rate. In Europe, by contrast, the British economy expanded by 1.9 per cent per annum, while the growth rate of France was only 1.6 per cent per annum. Germany grew at a 2.8 per cent annual rate because of the boost to productivity and output which resulted from unification. As a result of the rapid growth of output in the newly developing economies, there was an unprecedented expansion in the volume of international trade during the nineteenth century. In the century before 1913, it grew over twenty-five fold. Despite the spread of protectionism in the closing decades of the nineteenth century, the average growth rate of world trade remained at 3.4 per cent, compared with 2.1 per cent for industrial production. There was also an unprecedented migration of people from Europe to new regions of settlement as well as a large flow of people between European colonies in Asia and Africa due to labor demands created by the spread of commercial agriculture and industrialization. Between 1840 and 1940, over 40 million people left Europe for the New World or European colonies in the Pacific.

Technology played a major role in reducing the cost of both trade and capital transfers during the late nineteenth century. The introduction of the steamship and railways greatly reduced the cost of shipping goods over long distances. Developments in telecommunications also greatly reduced the cost of securities trading between different financial centers and thus encouraged more rapid growth of foreign investment. The first telegraph line between London and the European continent was laid in 1851 and traffic expanded rapidly during the next three decades. By 1889, 3.6 million telegrams per year were being exchanged between Britain and the rest of Europe. This total climbed to 6.5 million in 1907, or an amount equal to one telegram every five seconds. Cables to New York were laid in 1866, to Melbourne in 1872, and Buenos Aires in 1874. By 1880, there were nine cables to New York from London and the cost of telegraphs fell sharply.

Whereas a one-word telegram cost £20 ($100) in 1866, its price fell to £1 by 1902 and 10 pence by 1906.

In his famous 1919 treatise, "Economic Consequences of the Peace," John Maynard Keynes described how the process of global economic integration had altered the lives of ordinary people.

> What an extraordinary episode in the economic progress of man was that age which came to an end in August 1914. The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery on his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the towns people of any substantial municipality in any continent that fancy or information might recommend.
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> He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country and climate without passport or other formality, could dispatch his servant to the neighboring office or bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their relation, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as normal, certain and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous and avoidable.

This era of extraordinary human progress was shattered by the First World War. The war left Germany with a large reparations burden and political hunger for revenge which encouraged the triumph of the Nazi Party during the economic crisis of the early 1930s. Russia's military defeats in the initial stages of the war set the stage for Lenin's seizure of power in St Petersburg during 1917 and the emergence of communism as the twentieth century's great ideological rival to capitalism and democracy. The cost of the war forced Britain to liquidate a large share of her overseas investment portfolio, undermining her position as the world's banker and political support for the free trade policies which had been a natural counterpart of her capital exports. In the years immediately after the war, Britain attempted to restore the gold standard and London's former role as a world banking center, but she did not have the domestic price flexibility nor financial strength to restore the pound to its former parity vis-à-vis gold nor to export capital on as large a scale as she had done prior to 1914. The USA was prepared to assume Britain's role as the world's banker but she created a major bottleneck in the world economy by sharply increasing tariffs during the 1920s. America's protectionist commercial policies encouraged an upward spiral in tariffs all over the world during the late 1920s and early 1930s. This surge of protectionism greatly worsened the economic downturn which was already under way, causing world trade to shrink by half in value.terms and a quarter in volume terms during the 1930s.

The First World War occurred because the forces of global economic integration were not powerful enough to contain the tribal rivalries and ethnic nationalism which still dominated the European political landscape in the early twentieth century. Despite the internationalization of the marketplace for goods and capital, the political marketplace was still centered on the nation-state, and many governments continued to adhere to a mercantilist economic ideology. The USA maintained high tariffs throughout the nineteenth century in order to promote the development of manufacturing industries. Resentment of high tariff protection for the northern industrial states even played a role in encouraging the agricultural southern states to secede in 1861. After its political unification in 1870, Germany imposed high tariffs in order to encourage more rapid industrialization and catch up with British industry. Britain herself never restricted access to her domestic marketplace but she controlled the trade patterns of countries in the Empire, especially India, in order to earn a trade surplus large enough to compensate for her eroding commercial position in Europe and North America.

Although the London capital markets were relatively open, France and Germany tried to guide their capital exports towards countries which were perceived to be political allies or potential economic satellites. According to Feis, the French government monitored capital outflows very closely and tried to steer them towards political allies. France also was very sensitive about the deployment of her external wealth, because she had used foreign asset sales to pay German war reparations after her military defeat in 1871.

> Above and beyond all other considerations which induced French official intervention with the movement of French capital abroad was the wish to make the investment serve the political proposed of the stale. The reigning diplomacy of the day was the diplomacy of bargaining, and in that game, played with every resource of power and ingenuity, it was but natural that this precious ability to provide resources to needy governments should be fully appraised and used. Borrowing in Paris became as much the work of the foreign ministers as the ministers of finance of those loan-seeking governments that crowded the officials anterooms of the Quai d'Orsay. The saving French people gave this official intervention their approval. Financial nationalism corresponded to the state of mind of France.

One of the major beneficiaries of French government control over capital outflows was Imperial Russia. Bismarck had banned the sale of Russian bonds in Berlin during the 1880s on the grounds that they were a lowquality investment. The closure of the German capital market to "Russian junk bonds" proved to be one of the most fateful financial decisions of the late nineteenth century. For if Germany rather than France had financed the Russian railway system there might not have been a First World War or there might have been a very different outcome to the war. As Feis explained:

> From 1887 on, the prospective borrower at Paris had to satisfy the nervous judgment of two foreign offices, not one—the French and the Russian. Through the Financial Agent in Paris, through his friends in the French banks, and diplomatic agents in the world's capitals, all whispers of intended transactions reached the Russian Minister for Foreign Affairs as soon as they were uttered. Always alert, possessed of numerous political difficulties at almost all parts of its spreading frontiers, the Russian ally was no more backward in pressing its judgment of proposed loans to other countries than in presenting its own needs. Consent to its wishes in this field was claimed as an essential part of the political alliance. French financial relations with China and Japan, with Persia and Turkey, with the Balkan states and the Central Empires often followed the lines set by Russian political purposes rather than any direct interest of the French people. Russia had favors to bestow upon banks and financial journals so that its desires might be the more easily recognized. The dangers of this policy did not pass entirely unobserved.

As a result of this policy, France invested heavily in Russian bonds and had only modest investment exposure to Germany. Meanwhile, Germany also regulated her capital exports because she had a high domestic investment rate compared to Britain and her government believed that precious German capital should be allocated only to friendly countries. As Feis observed:

> To a student of German economic and financial affairs before the war, the nature and distribution of German foreign investment must have seemed satisfactory. With capital hardly more than sufficient to finance the advance of domestic enterprise, without many long-standing financial relationships with foreign countries, the German foreign investment seemed well placed where it could give most support to German economic life and policy. Of the foreign government bonds possessed, the largest part were bonds of the countries with which Germany wished to maintain close and friendly political relations and with which German commerce and industrial connections were growing stronger.

> The investment in industrial enterprises abroad, 'undertaking capital' as it was called in Germany, had gone mainly where it seemed likely to establish the leadership of German commerce and industry—in Central and Eastern Europe, North and South America. The German Government had, in general, permitted trade connections, natural diversity of resources and abilities, geographical propinquity, to have their effect.

The Germans were also much more aggressive than the British in using trade credits to boost exports. As Marcello de Cecco explained in his book on nineteenth-century financial history:

> According to Wolfe, German exporters were very flexible in determining the length of the credit they allowed their foreign customers. They took account both of the local conditions in the various markets and of the expediency of using credit terms as a method of sales promoting. In countries such as the United States, German exporters dealt mostly in cash or at very short-term. But in Latin American countries maturity could be extended to six months and sometimes even to twelve; in Central America and the West Indies the usual length of credit varied from four to nine months; in China and Japan from three to six months; in South Africa, the Dutch Indies and the Straits up to six months; while in North Africa and Asia Minor it could be as extended as long as nine months.
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> It is therefore hardly surprising that, when reading the reports of British Consuls, we find mentioned among the main reasons for the success of German exports the length of credit, compared with British practice. German exporting houses also frequently managed to persuade foreign clients to keep deposits with them or with German banks (on which, according to Wolfe, the clients received at 6% interest rate).

If the war had not intruded it is quite possible that the USA and Germany would have become stronger advocates of free trade during the 1920s because of their manufacturing success. Between 1870 and 1913, America's share of world manufacturing production had grown from 23.3 per cent to 35.8 per cent, while Germany's had grown from 13.2 per cent to 15.8 per cent. Britain's, by contrast, had shrunk from 31.8 per cent to 14.0 per cent. As a result of America's success as a manufacturing exporter, the first great move to cut tariffs in modern US history did not occur after the Second World War, when the USA emerged as a global superpower. The first great tariff cuts of the twentieth century occurred during 1913, when the USA reduced tariffs to a level which would not recur again until the late 1950s. Several factors encouraged the USA to slash tariffs in the year before the outbreak of the First World War. During the previous decade, the USA had pursued a number of bilateral tariff reduction agreements with Latin American countries. In each case, the tariff decline had produced an upsurge of exports and thus demonstrated the benefits of trade liberalization. By 1913, the USA was increasingly concerned also about the upsurge of protectionist sentiment in Britain, a country which still consumed about 25 per cent of American exports. The USA decided to open her market in order to persuade the British that they should retain free trade policies as well. The American move towards free trade in the years before the First World War has been overlooked in the recent popular debate about the relationship between America's strategic (military) interests and economic policies. It is commonly assumed that the USA embraced free trade only because of her post-1945 role as a hegemonic superpower. This perception is completely untrue. While there is no doubt that America's postwar role as a global superpower encouraged internationalist economist policies, the fact is the USA began to liberalize her trade policies, for purely commercial reasons, long before she became a superpower. She had a competitive manufacturing sector and thus she wanted to promote the growth of trade both in new markets (Latin America) and in traditionally important markets (Britain). If the First World War had not intruded it is quite likely that Germany also would have recognized the benefits of a more liberal trading regime for her own economic interests. In fact, the great irony of the First World War is that Germany was achieving such extraordinary economic success before 1914 that there is little doubt she would have dominated the European economy of the 1920s and 1930s if she had not permitted an alliance with Austria-Hungary to precipitate a war. German manufacturing output had overtaken Britain's in the early years of the century. The mark was increasingly gaining international acceptance as a reserve currency and denominator of trade. Because of Germany's heavy emphasis on promoting industrial competitiveness through universal education, cheap export credits and the creation of large capital-intensive corporations which utilized new technology, her manufacturing sector would have continued to out-perform the smaller, familycentered firms of Britain well into the twentieth century. Indeed, Britain began to organize technical schools for her own workers primarily because of concern over Germany's rapid economic advance.

After the Second World War, the leading Western nations consciously tried to recreate many elements of the international economic system which had existed in the golden age before 1914. They established the IMF to set rules for the conduct of exchange rate policy and international monetary relations, the World Bank to finance the reconstruction of Europe and economic development in the Third World, and the GATT to promote a liberal trading system. In the first two decades after 1945, these institutions worked extremely well and, as the average level of tariffs fell from 40 per cent to 5 per cent, there was a spectacular rise in the Western world's output and trade. In the 1960s, the major industrial countries also began to phase out foreign exchange controls, while the private sector circumvented the remaining ones through the creation of large offshore markets in banking and financial services. But the world order which emerged after 1945 was still far less liberal than the one which had prevailed in the golden age before 1914.

In the rich industrial countries there were far more restrictions on capital exports and trade in agricultural commodities than had existed before 1914. Although the GATT proved to be a great success for manufactured goods, the industrial countries imposed a growing number of restrictions on trade in textiles and crippled world trade in agricultural commodities by heavily subsidizing their own farm sectors. As a result, world imports of manufactured goods are now worth over $3 trillion, compared to only $820 billion for commodities, whereas in 1913 primary products accounted for about 64 per cent of world trade. In the 1970s and 1980s, many industrial countries also became less tolerant of large-scale immigration than they had been in the early twentieth century or in the years immediately after the Second World War. The USA and Australia reduced their controls on immigration from Asia but France, Britain and other European countries began to restrict immigration from countries which had previously enjoyed access as a by-product of their colonial status. Moreover, despite the risk of labor shortages in the early twenty-first century, there is growing political support in France and Germany today for imposing even tougher controls on immigration. Finally, the political legacy of the two world wars left the world far more ideologically and economically divided than it had been at any time since the start of the Industrial Revolution. After 1918, Russia rapidly withdrew from the world economic system. By 1949, two-thirds of Eurasia and over 1 billion people were living under communist rule. In the 1950s and 1960s, the liquidation of the European colonial empires in Africa and Asia led to the creation of many new and insecure political entities, which turned to interventionist economic policies in order to establish a stronger sense of nationhood and bolster the political power of the new elites that had assumed office from the old colonial rulers. Many countries which had been coloured pink on world maps in the days of the British Empire embraced economic ideologies which promoted state control over investment and import substitution rather than market-driven resource allocation and export-oriented growth.

Interventionist ideologies also became widely popular in Latin America during the 1950s. Countries, such as Argentina and Uruguay, which had prospered in the era of free trade through the export of agricultural commodities, slipped into a volatile economic stalemate of state-directed investment, forced import substitution, faltering productivity and disruptive political struggles over shrinking national incomes. Despite Brazil's industrial success, Latin America's export share of GNP fell from 20 per cent in 1900 to only 7 per cent. Many developing countries in Latin America and South

Asia still have far higher tariffs today than continental Europe had in the nineteenth century.

The political division of the world into market—and non—market—oriented economic systems coincided with a tremendous expansion of population in the developing countries and this magnified the impact of their deteriorating economic performance on per capita income growth. By the late 1980s, more than 3 billion people lived in countries with incomes under \$500 per annum, and another 500 million lived in countries with incomes of only \$500–1500 per annum. While there was not a perfect correlation between political system and income level, the vast majority of the world's poorest people lived in countries with command economies. Between 1950 and 1989, real incomes per head in Asia went up on average by 3.6 per cent per annum. During the same period in Latin America, they went up only a third as fast, or 1.2 per cent per annum. In Sub-Saharan Africa, real incomes rose by only 0.8 per cent per annum and during the past two decades they have actually shrunk. The countries which pursued market-oriented economic policies after 1945 also significantly out-performed the countries which led the Industrial Revolution in the eighteenth century and nineteenth century. Britain needed sixty years to double its real per capita income after the start of the Industrial Revolution in the 1780s. The USA needed fifty years to double its real per capita income after 1840 (although the Civil War delayed the change) and after 1885 Japan needed thirty-five years to do the same. But in the modern period, Brazil doubled its real per capita income in eighteen years after 1961 and South Korea did it in eleven years after 1966. The divergences in the communist world have been equally striking. Between 1977 and 1987, China was able to double its real per capita income through market-oriented reforms which boosted farm output and expanded foreign trade. In the USSR, by contrast, output has been stagnant or declining for several years. The recent IMF survey of the Soviet economy estimated that its real per capita income in 1989 was only \$1,700 per head, or less than Mexico's.

The division of the world into liberal, market-oriented economic systems and state-controlled economic systems after 1945 resulted from a variety of historical forces. The Second World War shattered Europe's willingness to sustain the cost of colonial empires in Africa and Asia. Many of the political leaders who took power in Africa, Asia and Latin America during the 1950s and 1960s had trained in European and North American universities at a time when the Great Depression had greatly eroded intellectual support for market-based economic systems, and the Soviet Union itself was widely regarded as an economic success. The industrial nations then encouraged economic nationalism in the developing countries by themselves pursuing discriminatory trade policies in agriculture and textiles while channeling capital flows to the Third World through official assistance programs rather than market-oriented economic institutions comparable to the pre-1914 London capital market.

The end of the great political and ideological schism which developed in the international economy after 1945 has created the potential for an extraordinary new burst of human progress comparable to that which occurred during the nineteenth century through the spread of technology and the development of the so-called "regions of recent settlement." Just as the growth of output, investment and trade during the nineteenth century was spurred on by the creation of a global marketplace for goods and capital encompassing many new regions, so could the world economy of the 1990s benefit from the liberalization of the command economic systems, where over 3 billion people have been living far below their productive potential for several decades. Indeed, the term "regions of market re-entry" could become as popular a term for the economic classification of former state-controlled countries during the 1990s as was the expression "regions of recent settlement" among the economic historians of the early twentieth century.

ECONOMIC CONSEQUENCES OF THE STOCK MARKET BOOM IN THE DEVELOPING COUNTRIES

The rebirth of developing country stock markets has already had a positive impact on their ability to import capital and boost their rates of investment growth. International capital flows to emerging country stock markets shot up to $52 billion during 1993 from $15.8 billion during 1991 and $3.4 billion during 1988. Developing countries have also improved their access to global bond markets. In 1993, they were able to sell $84 billion of bonds in the international capital market compared with only $28.6 billion in 1990.

The recovery in the capital access of the developing countries has had a transforming impact on Latin America's balance of payments. According to the World Bank, total securitized capital flows (equity, bonds, commercial paper) to Latin America rose to $19.2 billion in 1992 from only $1.4 billion in 1990. As the growth of capital inflows often exceeded import demand, Latin America's foreign exhange reserves also shot above $100 billion in late 1993, the highest level this century. Ironically, some Latin American countries, such as Mexico and Argentina, have had problems controlling the monetary side-effects of the large capital inflows. Because they are trying to adhere to fixed exchange rate targets for their currencies, they sometimes found it difficult to sterilize fully the growth of their foreign exchange reserves. The countries of East Asia have also benefited from the growth of foreign investor interest in developing country equity markets but, since their domestic savings rates are much higher than Latin America's, the impact on their economic performance has been less dramatic. The savings rate of developing countries in the western hemisphere is only about 17 per cent compared to 30 per cent for Asia. Some East Asian nations, such as Thailand and Malaysia, have also been able to finance large external deficits primarily through an upsurge of foreign direct investment from Japan. In the case of Thailand, Japanese investment has become so large that Japanese firms now employ 7 per cent of all Thai manufacturing workers.

Governments in the newly market-oriented economies have been promoting capital flows through security markets by liberalizing restrictions on foreign investment and privatizing state owned enterprises. As a result of the initial success of countries such as Mexico with asset privatizations, the volume of privatizations in the developing countries has expanded from \$2.6 billion in 1988 to \$17.4 billion in 1991 and \$23.2 billion in 1992. Privatizations in the developing countries accounted for nearly half of the \$47.7 billion of privatization which occurred in the world last year compared with only 6 per cent of the \$39 billion which occurred during 1988. The boomlet in privatizations has helped also to encourage a return of the flight capital which left Latin America during the 1980s debt crisis. At the height of the debt crisis, some analysts estimated that wealthy Mexicans had more deposits in the US banking system than the American banks had loans in Mexico. In the 1990s, other newly market-oriented economies should also be able to attract home flight capital by privatizing assets. As a result of the collapse in the value of the ruble, for example, many Russian exporters have been stockpiling dollars in foreign bank accounts. If Russia can create a sound currency and credible asset markets it might be able to repatriate as much as \$15–20 billion of its flight capital, or a sum in excess of the official assistance it has been receiving from the West.

The economic liberalization policies of the 1990s have permitted the developing countries to expand their share of world trade, not just global capital flows. Between 1986 and 1991, their GDP share of imports from the industrial countries rose to 13.9 per cent from 12.1 per cent, while their GDP share of exports to industrial countries rose from 13.5 per cent to 15.0 per cent. The USA has benefitted greatly from the improved economic conditions in Latin America. During the period 1990–2, US exports to Latin America grew at a 16.5 per cent annual rate compared with only 3.5 per cent for the major industrial nations.

The World Bank recently revised its estimates of world GDP to reflect the increasing importance of the developing countries to the global economy. By adjusting its previous estimates of nominal GDP for purchasingpower parity differences, the World Bank has revised upward, from 17 per cent to 34 per cent, its estimate of the share of world output in the developing countries. The former communist countries account for an additional 11 per cent. According to the new tables, Asia accounts for 17.7 per cent of world output compared with 7.3 per cent previously, Latin America accounts for 8.2 per cent compared with 4.4 per cent before, and Africa accounts for

4.05 per cent compared with 1.7 per cent previously. There were downward adjustments in the shares of all the industrial nations but the most severe was in Japan because of its high prices for land and many other goods. According to the new PPP-based tables, Japan's share of world output is only 7.6 per cent compared with 14.6 per cent previously. The global share of European GDP also drops from 24.8 per cent to 18.5 per cent, while the US share goes from 26 per cent to 22.5 per cent.

As the developing countries account for about 80 per cent of the world's population, there are likely to be further dramatic changes in the composition of world output during the 1990s. In fact, demographers project that practically all of the growth in the world labor supply during the next half century will occur in the developing nations. The birth rates of Europe and Japan have fallen to such low levels that their indigenous populations will soon be shrinking. As a result, there will either be large-scale migration of labor from the high-population developing countries to the old industrial nations or an outflow of capital to create new sources of output in the developing countries. Until recently, the primary adjustment to labor scarcity in North America and Europe has been an influx of people from poor countries in the South. But, with the developing countries now embracing market-oriented economic systems, there could be a transfusion of capital from the rich North to developing countries on as large a scale as occurred during the nineteenth century. Indeed, it would not be an exaggeration to suggest that the pension systems of the aging populations of Europe, Japan and the US may ultimately become dependent upon the successful investment of their surplus savings in the new, high-return stock markets of the developing countries with young, expanding populations.

NEW CHALLENGES

The structural changes now occurring in the composition of global capital outflows and world output will pose numerous challenges for the international economic order which evolved during the Cold War era. There will be many new entrants to the world trading system, who will have very different economic and political traditions to the existing players. These new players could produce new tensions over trade policy even greater than those which developed as a result of Japan's rise as a major industrial power. While these new players are embracing market-oriented economic policies, it is doubtful that they will create capitalist systems any more identical to the American one than other countries which industrialized late. In some cases, these countries also have authoritarian political regimes, which could provoke concerns about human rights abuses.

These factors suggest that, despite the recent completion of the GATT talks and the successful completion of regional economic trade agreements such as NAFTA, trade tensions between the old industrial countries and the newly market-oriented economies will not fade away. Instead, the focus of the trade disputes will shift away from explicit tariffs and quotas to other forms of protection, including dumping litigation and attempts to link market access for the developing countries to their environmental and human rights policies.

At the Bretton Woods Conference, there were attempts to establish a new world trade organization but, despite the subsequent success of GATT, they were never carried out. The Uruguay Round of the GATT has set the stage for the creation of a new World Trade Organization to serve as a monitor for the international trading system and as a referee in resolving trade disputes. Establishing the WTO as an effective guardian of the multilateral trading system will not be easy: there is formidable opposition to further liberalization of all forms of trade, while the developing countries themselves are increasingly resorting to dumping litigation in order to block exports from the old industrial countries. Many American Congressmen are also increasingly attracted to the idea of creating "blue and green" 301 trade laws, which would require other countries to offer more protection for both workers and the environment in return for enjoying access to the US marketplace. Although the NAFTA Treaty has set a precedent for labor and environmental side-agreements, there is a risk that such demands could evolve simply into a new form of trade protection if not held in check by a new multilateral organization such as the WTO.

It also would be useful for the new WTO to play a role in promoting further liberalization of policies in the developing countries which regulate foreign direct investment. In the modern era, there has been a significant increase in the linkages between foreign trade and investment. Since the sales of multinational companies in foreign countries now greatly exceed the level of world trade, corporations no longer focus solely on exports as a means of expanding sales. In the case of the USA and other industrial countries, a growing share of exports also consists of shipments between the divisions of multinational companies. One of the reasons the USA has such strained trade relations with Japan is that it has far less direct investment there than in other industrial countries. In 1992, the ratio of US foreign trade to investment in Japan was 5.5 compared with only 1.0 for Europe and 1.5 for Latin America. Japan restricted foreign investment during the first three decades after the Second World War, and after it relaxed the controls during the 1980s the yen rose to such high levels that many foreign firms regarded investment there as too costly. As a result, many American firms not only lack manufacturing facilities in Japan; they also have poorer access to the Japanese distribution system than they do in countries where they are significant investors. The developing countries should learn from the Japanese example and attempt to reduce the potential for future trade tension by encouraging a higher level of foreign direct investment than occurred in Japan durng the 1950s and 1960s. In the case of East Asia, trade with the USA has been expanding so rapidly that the ratio of trade to direct investment has risen to 3.72 but, with US firms now showing greater awareness of the growth opportunities of China and other countries in the region, the ratio of trade to investment should decline in the future.

Pessimists contend that it will be difficult to prevent a slide towards protectionism because the USA no longer has the same political incentives which existed during the Cold War era to promote free trade. While it is easy to understand why this view has become so fashionable, it reflects a very limited awareness of American history. The fact is the first great American move in the direction of free trade did not occur after the Second World War. It occurred instead during the years immediately before the First World War. In 1913, the US Congress voted to eliminate tariffs on many imports and to reduce the remaining tariffs to levels which would not be achieved again until the late 1950s. The American move towards free trade in the years before the First World War has been overlooked in the recent popular debate about the relationship between America's strategic (military) interests and economic policies. It is commonly assumed that the USA embraced free trade only because of her post1945 role as a hegemonic superpower. This perception is incomplete. The fact is the USA began to liberalize her trade policies, for purely commercial reasons, long before she became a superpower. She had a competitive manufacturing sector and she thus wanted to promote the growth of trade in new markets (Latin America) while retaining access to traditionally important markets (Britain).

Despite the large decline in the American share of global GDP since 1950 (from 50 per cent to about 22 per cent), the USA continues to have a strong commercial interest in supporting free trade. The USA is a clear leader in many high-technology industries. The American dollar is very competitive. The USA has far stronger trade and investment links with many developing countries in East Asia and Latin America than does Europe. As the USA has become an external debtor and will probably continue to be a captial importer for several years, she also has a new strategic interest in pursuing policies which encourage export-led growth. As a result, the USA may continue to pursue aggressive trade policies in the name of market opening, especially vis-à-vis Japan, but she is unlikely to impose significant new import barriers unless there is a return to financial conditions which produce a significantly overvalued dollar exchange rate.

The greatest protectionist risk during the next decade will probably be in Europe. It currently suffers from high rates of unemployment, it has lagged in the creation of competitive high-technology industries and there is a long tradition of mercantilism in some Southern European countries. But despite the poor performance of the European economy during recent years, the community has not been able to withstand global pressure for further trade liberalization. There will be some relaxation of European agricultural trade barriers and a reduction in farm subsidies during the late 1990s. The European Community has agreed to provide much improved market access for manufactured exports from several Eastern European countries. Some European countries are far stronger supporters of both the GATT and the new World Trade Organization than is the US government. But, so long as Europe has high unemployment, there will be a risk of trade policy regressing in a more protectionist direction. As a result, the conduct of macroeconomic policy during the next five years will probably be as influential in shaping the evolution of trade policy as the debate about the GATT, regional trade agreements and the other aspects of microeconomic policy which influence market access in the European Community.

The recent Uruguay Round of the GATT talks was the first to encompass a large number of developing countries. As the talks extended over a multi-year period spanning the collapse of communism, they inadvertendy came to play a role which encompassed many of the functions of the Bretton Woods Conference of 1944–5. They were the only international economic forum at which both the industrial countries and the developing countries were able to address many of the anxieties and tensions which have been created by the arrival of so many new players in the global economic system. But since the original agenda of the Uruguay Round predated the end of the Cold War, there are still many questions which will have to be addressed by the new World Trade Organization. In the aftermath of the Bretton Woods Conference, the GATT system was able to evolve without the benefit of a large, permanent secretariat because there was a consensus among the major industrial nations about many aspects of trade policy. In the new, increasingly multi-polar global economic system resulting from the end of the Cold War, the trading system will need an institution such as the WTO to referee the commercial disputes which will result from the increasing integration of countries with very divergent levels of economic and political organization as well as highly unequal levels of income.

MANAGING THE WORLD BUSINESS CYCLE AND BOOSTING SAVINGS RATES

The second policy challenge facing the G7 countries will be to pursue macroeconomic policies which promote world economic integration by producing less extreme business cycles than occurred during the early 1990s. This challenge will have several dimensions encompassing both macroeconomic and microeconomic policy. There will have to be continued exchange rate flexibility in order to permit the world economy to adjust to the relative price shocks resulting from the return of 3 billion people to the global marketplace for goods and capital. The European Economic Community will have to curtail many of the restrictive labor market practices and payroll taxes which have inhibited its employment creation since the 1960s. There will have to be further attempts to bolster the savings rate of the western hemisphere countries and reduce European government deficits in order to lessen the risk of a global savings shortage and large increases in real interest rates during the second half of the 1990s.

Since 1992, the primary growth locomotive of the world economy has been the American recovery. The credit crunch which strangled small business job creation during the early 1990s has abated, and the USA is now enjoying robust growth in both private consumption and investment, while fiscal policy remains contractionary. There are increasing signs of economic recovery in Europe as well. As a result of the currency realignment and interest rate declines which occurred during late 1992, Britain, Scandinavia, Italy and Spain are enjoying a mixture of improved export growth and modest growth in domestic consumption. The German economy is enjoying an upswing in demand for capital goods exports as a result of the expansions under way in the USA and East Asia. But it will be difficult for Europe to translate this modest upturn in exports and domestic spending into American-style job creation until there are major changes in employment policies, including expensive, mandated benefit programs, high redundancy costs and uncompetitive minimum wages.

Japan continues to have the weakest economy in the G7 because of the triple shock of a banking crisis, the strong yen and a multi-year recession in business capital spending. There will be a personal tax-cut this summer [1995] but total personal income growth will continue to be constrained by the huge erosion which has occurred in corporate profits since 1989 (80 per cent). The US Treasury has criticized Japan for not pursuing a more expansionary macroeconomic policy despite the fact that her ratio of net public to GDP is only about 6 per cent. But, because there is no internal consensus about how to reduce the budget deficit in the late 1990s, the Japanese government has been unable to enact large, multi-year tax-cuts. The MOF is opposed to deficit financing of any form, while the Socialist members of the new coalition government have rejected proposals to follow up income tax-cuts with a hike in the consumption tax from 3 per cent to 7 per cent after 1995.

While this policy impasse suggests that Japan's recovery will lag behind the 1995–6 global upturn, the current account surplus could still shrink in response to the strong yen, boosting real imports and raising prices for commodities. What remains unclear is whether other G7 countries will view Japan's remaining external surplus as a problem if the world starts to experience sharply rising interest rates because of a collision between capital demands from the newly market-oriented economies and the old industrial countries. At the present time, because of savings imbalances resulting from large government deficits or low private savings rates, most industrial countries are running modest current account deficits. These deficits are potentially troublesome, because the old industrial countries should now be deploying surplus savings in the new high-growth, market-oriented economies, not importing capital. In 1993, the industrial countries had a gross savings rate of 19.4 per cent compared with 23 per cent during the late 1970s. The private savings rate of the industrial countries has dropped to 19.8 per cent from 21.5 per cent, while the public sector has shifted from positive savings equal to 1.4 per cent of GDP to a deficit of 0.5 per cent of GDP. In the absence of Japan, the deterioration in OECD savings rates would have been far larger. In the USA, the gross savings rate dropped from 20.8 per cent during the late 1970s to 14.8 per cent in 1993, with the private savings rate falling from 18.8 per cent to 16.1 per cent and the public sector swinging from a savings surplus of 1.9 per cent of GDP to a deficit of 1.3 per cent of GDP. In the European Union, the savings rate has dropped from 21.7 per cent to 18.7 per cent because of a shift in the public sector's financial position from a surplus of 0.2 per cent of GDP to a deficit of 3.2 per cent. By contrast, the private savings rate in Europe has increased from 21.5 per cent to 21.9 per cent.

The inadequate level of surplus private savings in the old industrial countries excluding Japan suggests that the recent upswing in world bond yields did not result only from investor apprehension about inflation. It probably also resulted from investor concern about an upturn in private credit demand, from both the old industrial countries and newly market-oriented economies, colliding with low private savings rates and large government deficits during the mid-1990s. Real interest rates are rising because investment intentions are rising more rapidly than the world supply of excess savings. Table 3 shows projected changes in the current account balances of thirty-three newly market-oriented economies as well as in some of the successful East Asian developing countries during the mid-1990s. In 1995, this group could have a combined current account deficit of $66.6 billion, compared with a surplus of $8.2 billion in 1989. If we subtract Taiwan and Hong Kong, the deficit total rises from $13.4 billion in 1989 to $83.1 billion.

North America and Latin America could be the most vulnerable to such a collision because every nation in the western hemisphere is currently an external debtor and often a capital importer. The developing nations of the western hemisphere had a gross savings rate of only 16.6 per cent during 1993, compared with 17.4 per cent during the early 1980s and 20.7 per cent during the late 1970s. In Asia, by contrast, the gross savings rate was 29.7 per cent last year compared with 26 per cent ten years ago. Several of the newly market-oriented economies in Latin America are attempting to bolster their private savings rates by promoting the growth of pension funds and reducing tax rates on investment income. But as the large current account deficits of Mexico, Argentina and other Latin American nations will testify, this process is still in its early stages. The Latin American savings rate needs to rise by at least 4–5 per cent as a share of GDP in order to reduce the continent's vulnerability to sudden disruptions of capital flows from the northern hemisphere.

THE EXCHANGE RATE SYSTEM

One of the most complex macroeconomic policy changes in the new international economic order will be the development of monetary policies which promote exchange rate targets which, in turn, encourage the growth of world trade while restraining inflation. During the early 1990s, it was often argued that the return of 3 billion people to the global marketplace for goods and services would generate deflationary price impulses comparable with those which occurred in world agricultural markets after the opening of America, Australia, Argentina and other new regions of settlement during the late nineteenth century. But in the period after 1870 there were two factors which encouraged falling prices. Prices fell not only because of rising output, from new regions of settlement, but also because the growth rate of the world money supply was restrained by the spread of the gold standard. The gold standard made it impossible for governments to offset the large rise in output with faster expansion of the money supply. In the USA, the western farmers formed a populist political party to lobby for a bi-metallic gold/silver standard, which would have greatly expanded the money supply, but their proposals were rejected by the eastern states. They feared the populist agenda would produce hyperinflation and were concerned about losing access to the British capital market (which then provided the USA with capital inflows equal to 1–2 per cent of GNP per annum). In the 1990s, by contrast, the world has a floating exhange rate system, which should greatly reduce the risk of a sustained monetary contraction occurring in the global financial system.

It is important to recognise the role of monetary policy in the nineteenth century deflation, because it is possible to construct scenarios in which the post Cold War world economic order produces not just continued commodity gluts but also a large rise in goods prices during the late 1990s. During the past two years, base metal prices have slumped to record lows because total output growth in the old industrial countries has been less than 1.0 per cent, while Russia has been dumping commodities formerly consumed by its large military industrial complex. The only robust economies since 1991 have been the countries of East Asia and Latin America, but their nominal purchasing power is still less than 50 per cent of the US economy's. Imagine, however, what could happen to raw material prices if the major industrial countries return to a trend growth rate of 3.0 per cent, East Asia and China expand at a 7–8 per cent annual rate, Latin American growth stabilizes in the 4–5 per cent range and Russia reorganizes its economy to produce more goods for local consumption, not just military equipment and raw materials for export. By 1996 or 1997, despite the abundance of low-cost labor in the developing countries, there could be capacity constraints and rising prices for many commodities. Some analysts also have noted that in the developing countries themselves labor is so cheap that raw material costs represent a much larger share of total output costs. As a result, manufacturers in those countries will have less room in their profit margins to absorb any increase in raw material prices than would be the case for producers in the old industrial countries, where non-raw material costs are a much higher share of total costs.

It is possible that the abundance of low-cost labor in the newly emerging market economies will have such a powerful effect on wage behavior that the impact of rising commodity prices on the world economy will be offset by further erosion of real wages in the old industrial countries. But, as the sharp rise in the real wages of many East Asian nations during the past decade has demonstrated, skilled labor itself could become a scarce resource in many of the new high-growth economies because of the speed at which they are boosting investment and creating new employment. As a result of these factors, it would be dangerous to extrapolate the deflation of the early 1990s through the entire decade. The world is in the early stages of adjusting to massive geopolitical and geo-economic shocks which have so far had a greater impact on supply than on demand. But, as it will take several years for the full consequences of these shocks to work their way through the marketplace for goods and capital, there will be secondary and tertiary consequences which could reverse many of the initial effects. In the short-term, low-cost labor has become more abundant and will probably restrain the wages of unskilled workers everywhere. But the expansion of the global marketplace to include dozens of new countries has increased the demand for many people with highly specialized skills and thus permitted them to boost their incomes. The demand for capital is also likely to increase significantly during the mid-1990s and thus boost real interest rates, despite subdued wage growth for many categories of workers. Finally, as incomes rise in the newly emerging market economies, they will create a large new demand for many commodities which will not be satisfied without higher prices.

In a recent book, *Monetary Mischief,* Dr Milton Friedman analyzed the deflation which occurred in global prices during the late nineteenth century and attempted to model how prices would have performed if the USA had pursued the bi-metallic gold/silver monetary system proposed by western populists. In the simulation, Dr Friedman estimated what would have happened to the US price level if the silver price had been stabilized at a ratio of 16 to 1 vis-à-vis gold instead of being permitted to drop to 40 to 1. The simulations showed that, despite the huge rise in world output, there would have been much less deflation than actually occurred. Dr Friedman reported:

> The actual price level in the United States fell at a rate of 1.5 percent a year from 1876 to 1896 and then rose at a rate of 2.0 percent a year until 1914. The 16 to 1 price level first falls by 0.7 percent a year to 1896 and then rises by 2.3 percent a year to 1914. The hypothetical price level falls at a rate of 0.2 percent a year from 1876 to 1887 and then rises at a rate of 1.1 percent a year to 1914. Either alternative would have cut the initial rate of decline in half. The 16 to 1 alternative implies a slightly more rapid subsequent rise, the hypothetical alternative a much milder rise. If my estimates are anywhere near correct, a bimetallic standard—really a silver standard—would have produced a considerably steadier price level than did the gold standard that was adopted.
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> In addition, a silver standard almost surely would have avoided what Anna Schwartz and I, in our *Monetary History,* dubbed 'the disturbed years from 1891 to 1897' (Friedman and Schwartz 1963, p. 104)—years that encompassed the very sharp contraction of 1892 to 1894, a brief and mild recovery from 1894 to 1895, another contraction from 1895 to 1896, widespread bank failures plus a banking panic in 1893, and a run on U.S. gold reserves by foreigners fearful that silver agitation would force the United States off the gold standard. Confidence was restored and a departure from gold prevented by a private syndicate headed by J.P.Morgan and August Belmot, under contract to the U.S.Treasury. The allegedly onerous terms of the contract, arranged secretly through agents long identified in Populist literature as 'the conspiracy of international bankers,' became an issue in the campaign of 1896 (Friedman and Schwartz 1963, p. 112n.).
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> The effects would not have been limited to the United States, of course. I have not been able to make anything like as thorough an empirical study for the rest of the world as for the United States. However, in the course of preparing the U.S. estimates, it was necessary to estimate the effect on the price level in the gold-standard world, for which I used Britain as a proxy.… The estimated effect, though smaller than in the United States, is clearly substantial. The price level would have been consistently higher. The decline in the price level from 1875 to 1895 would have been cut from 0.8 percent a year to 0.5 percent; the subsequent rise would have been increased from 0.09 percent a year to 1.1 percent. Here, too, however, effects other than those encompassed in our simple calculation would clearly have been present. The changes in the United States would doubtless have produced echoes elsewhere. A healthier U.S. economy would have meant a healthier world economy. In addition, the consistently lower real price of gold would have reduced the incentive to produce gold. That might have

delayed the introduction of the cyanide process for extracting low-grade ore, which was responsible for the flood of gold that produced world-wide inflation after 1896. I have not allowed for any such effects.

As the mismanagement of European exchange rate policy between 1991 and 1993 illustrated, it will not be easy for the major industrial nations to develop effective monetary policies for responding to the challenge posed by the vast changes in output and relative prices resulting from the return of over 3 billion people to the global marketplace for goods and capital. France, Italy and other European countries attempted to peg their exchange rates to the deutschmark despite the price shocks produced by the fall of the Berlin Wall and the transformation of Germany from a low government deficit/capital-exporting nation into a large public-sector deficit/capital-importing nation. But if G7 monetary policy can be targeted on more realistic goals than it was in Europe during the early 1990s there is no reason why the coming surge in world output has to produce as disruptive a deflation as occurred during the final decades of the nineteenth century. On the contrary, the large rise now occurring in consumer and capital spending in the newly emerging market economies suggests that rising commodity prices and higher inflation will be a risk in the middle stages of the next global business upturn. In fact, many commodity prices rose sharply during the first half of 1994 simply because of a recovery in US output.

The more daunting challenge for policy-makers will be to develop rules for an exchange rate system which lessens the potential for trade tensions resulting from currencies becoming significantly undervalued or overvalued on a commerical basis. In recent years, the US Treasury has often demanded that the newly industrializing East Asian countries revalue their currencies in order to reduce large trade surpluses. It also has demanded the reform of financial regulations which inhibit free movements of capital and thus contribute to currency undervaluation. But, with so many new countries now entering the global marketplace for goods and capital, the US Treasury cannot play effectively the role of financial policeman and exchange rate guardian for the whole international system. Instead, the new World Trade Organization or a revitalized IMF should be encouraged to develop a currency surveillance system for determining whether exchange rates are supportive of an open trading system.

In the aftermath of the Second World War, the USA, Britain and the other victors established a new international monetary system which had pegged potentially adjustable exchange rates. The system was designed to limit exchange rate volatility by offering countries access to special lending facilities during emergencies (the role of the IMF) and negotiating a currency realignment if it became necessary.

Four factors made it possible for the countries at the Bretton Woods Conference to agree on rules for a new exchange rate system and adhere to them until the late 1960s. First, the USA and Britain dominated the Conference, while all of the other key players were European or from countries which were inhabited by people of European ancestry. The Bretton Woods system was in many ways a North Atlantic economic zone. Second, there were acute memories at Bretton Woods of how exchange rate misalignment or competitive devaluations had undermined the world trading system during the interwar years. Such memories made it easier to achieve a consensus on new rules of conduct. Third, international private capital flows were insignificant during the first decade after the Second World War because most countries had exchange controls, while asset markets were often closed. Finally, once the fixed exchange rate system was put in place, there was intensive cooperation between key governments to support it because of perceived links between financial stability and the cohesion of the larger western alliance, which was then waging a Cold War against the Soviet Union. In the 1960s, for example, the USA made secret currency support loans to Britain as a quid pro quo for her military role in East Asia. At the same time, Germany agreed to hold dollars rather than gold in her official foreign exchange reserves in order to generate a balance of payments offset to American defense spending in that country.

The situation today is very different from the period after the Second World War. As a result of the break-up of the European colonial empires and the Soviet Union, there are now over 200 independent nations today compared with several dozen in 1945. In 1994, the real GDP of the USA and Europe combined accounts for only about 45 per cent of world output compared with 50 per cent for the USA alone in the late 1940s. There is not a clear intellectual consensus about the rules for managing nominal exchange rates nor even a widespread agreement that they matter. Private capital flows are now so large that they can easily overwhelm official intervention if investors perceive that a currency is significantly misaligned. The end of the Cold War has reduced the willingness of governments to use exchange rate intervention to promote political objectives such as sustaining security relationships.

As a result of these new constraints, the rules for a new post Cold War exchange rate system will have to be far more flexible than the fixed exchange rate system which was created after the Second World War. It will be impossible to peg exchange rates in target bands as narrow as those which existed during the 1950s and 1960s, but there is a good case for developing surveillance indicators to determine when exchange rates are significantly misaligned and are thus a potential source of trade conflict. What remains unclear is who should assume this function. In theory, it should be the responsibility of the IMF, but during recent years the IMF has lost much of its influence over the exchange rate policies of the industrial countries. The IMF did not play a role in designing the G7 exchange rate accords of the 1980s and it remained passive in the face of the absurd European monetary policies of the early 1990s. In fact, it would not be an exaggeration to say that the Bank for International Settlements has had more influence than the IMF on the economic policies of the industrial nations during recent years because of its role in designing bank capital adequacy standards and other financial rules which have had a major impact on credit availability. The IMF has played an important role in designing structural adjustment programs for developing countries and it could ultimately emerge as an important player in providing lending facilities as well as economic advice to the former Soviet Union. But these functions are increasingly giving the IMF the character of a development bank for distressed emerging market economies and diminishing its role as a steward of the global financial system.

As there is no consensus about revitalizing the IMF or creating a new institution to develop monetary rules for promoting global economic integration, an interim solution to the problem of exchange rate misalignment might be to have the new World Trade Organization assume responsibility for publishing currency surveillance indicators. There is a broad consensus that exchange rate movements affect trade competitiveness and thus there would probably be more political acceptance of exchange rate advice focused specifically on reducing trade conflict than on larger macroeconomic objectives. Despite its ideological hostility to currency market intervention, even the Reagan administration felt compelled to modify its exchange rate policies when the upsurge of the US trade deficit during the mid-1980s threatened to encourage Congressional support for highly protectionist trade legislation.

Assigning the WTO a role in monitoring the exchange rate system would not preclude the IMF, G7 central bankers and other international financial organizations from also attempting to pursue bilateral or multilateral agreements about exchange rate policy. But, as the failure of the European exchange rate policy of the early 1990s and the limited success of other G7 efforts at exchange rate management have demonstrated, there are limits to how far national monetary policies can be forced to converge when the international system is experiencing massive geo-politically-driven price shocks. Instead of a return to pegged but adjustable exchange rates, we shall probably have to accept a prolonged period of guided floating aimed at avoiding real exchange rate disequilibria on a scale which would encourage protectionism in the old industrial countries and distort resource allocation in the newly emerging market economies.

ADDING SOCIAL SAFETY NETS

The final great challenge facing the old industrial countries in adjusting to the new international economic order will be addressing the fears of their own workers about the prospect of increased competition with low-wage developing countries. They will have to devise policies which help workers to adjust to structural change so that they do not rally around protectionist political movements.

There are great divergences in the social safety nets of the G7 countries. The USA currently has a far more modest social saftey net for unemployed workers than other industrial countries. Public expenditure on employment insurance as a share of GDP is a third of that in the United Kingdom and a quarter of that in Canada, France and Germany. American expenditure on other labor programs is also far below other industrial countries, except Japan. The USA spends about 0.05 per cent of GDP on job training programs compared with 0.22 per cent in Canada, 0.22 per cent in the UK, 0.25 per cent in Germany and 0.28 per cent in France. The US training expenditure per participant is $1,800 compared with $7,000 in Canada, $4,600 in France, $7,200 in Germany and $5,000 in the UK. The US participation rate itself is also half or a third less than that in the other industrial countries.

As a result of the modest scope of unemployment benefits in the USA compared with other industrial countries, the American labor market clears far more effectively than the labor markets of Europe. The USA has a much lower unemployment rate than Europe and a much smaller share of its unemployment is long-term in nature. According to OECD data, only 11.2 per cent of US unemployment is long-term, compared with 45 per cent in Germany, 39 per cent in France, and 28 per cent in Britain. The US labor market has produced much lower unemployment rates than in Europe because American wages have been far more flexible than European wages. During the past decade, real wages for unskilled workers in the USA have fallen at 1 per cent annual rates, compared with gains of 3–4 per cent in Germany and France.

During the 1992 presidential election campaign, Governor Bill Clinton, under a manifesto called “Putting People First,” campaigned for more activist government policies to help American workers. Using Germany’s employer-based system of mandated benefit programs as a model, Clinton promised to introduce comprehensive national health insurance, a 1.5 per cent payroll tax to finance more extensive workplace education programs, and greater public investment in human capital than had occurred during the Reagan-Bush years. Since the election, both the President and other Democratic lawmakers have emphasized the theme of middle-class economic security as a new goal for US social policy. While it is easy to see why the Democrats have been attracted to the theme of economic security, there are three major problems with the Clinton program as it has so far emerged.

First, the President has little room, under the budget rules for domestic discretionary spending enacted during 1990 and amended during 1993, to expand public outlays on social safety-net programs, including worker training. In his most recent budget, he announced proposals to boost public spending on worker education at the expense of other domestic programs, but it is still unclear if the Congress will be prepared to accept all of his proposed cuts. If the Clinton proposals are accepted the US training programs also will continue to be modest compared with other industrial countries. Second, the President has decided to make health insurance the anchor of his economic security agenda, not human capital investment, or other programs more directly focused on boosting productivity and competitiveness. The Clinton health care agenda will pose a variety of challenges for the administration's other economic objectives. The program would be financed through a new system of employer mandates, which would be a de factor employment tax and which would thus retard job creation. The Congressional Budget Office also estimates that the program will significantly expand federal outlays during the next decade and thus further limit the amount of money which will be available for other domestic discretionary programs, such as education. It is possible that the Clinton program will reduce health care spending in the long-term, but during the next five years it will both retard employment growth and constrain the federal government's abiity to pursue other forms of public investment. Finally, as a result of its preoccupation with health care, the Clinton administration still has not articulated a clear vision of the trade-offs between economic security and other policy objectives. There is no doubt that the USA needs a more effective social safety-net for many groups of people, but the recent history of Europe demonstrates that increased public expenditure alone will neither create jobs nor encourage job mobility. In the past, the USA has offered some targeted relief programs for workers suffering from trade-driven employment losses, but these programs are so narrowly focused that they are far from adequate for addressing the economic insecurities created by the wide-spread American corporate restructuring now under way. Since 1980, the Fortune 500 companies have reduced their employment from 16.8 million to 11.5 million and the process of labor-shedding appears to be still under way. Much of the increase in middle-class anxiety about economic security has resulted from the job losses at these large, hitherto stable, employers.

Despite the severity of the recent recession in Japan, unemployment has not risen sharply, because Japanese firms typically regard their workers as permanent capital, not as a flexible unit of production to be scrapped during business cycle slumps. One of the explanations for this attitude is that Japanese firms invest heavily in human capital and encourage frequent job rotation within companies. Workers, meanwhile, expect to remain with the company for many years, if not for their whole working life, and thus help to protect the firm's investment in their training. American culture would not be as supportive of lifetime vocations within a single company as Japan's has been, but American firms would probably have a different view of human capital (and job preservation) if public policy was more supportive of investment in workplace education and job rotation within firms.

The developing countries also will have to develop new safety-net programs to help their populations cope with the traumas of economic liberalization, accelerated industralization and increased urbanization. While most of the developing countries have boosted spending significantly on physical infrastructure during recent years, investment in human capital has been more uneven. The expanded role of private capital in the development process also suggests that there should be a major re-examination of the role of official lending institutions, such as the World Bank and the IMF, in the development process. Should the World Bank provide capital for projects which can be financed easily in the private sector (say a Chinese cement factory)? Should the World Bank now refocus its efforts on countries unable to attract private capital (Africa) or on social groups lagging behind the economic modernization process in the successful developing countries (say, Mexican Indians)? Should the IMF continue devoting even more of its staff and resources to guiding structural adjustment programs in the developing countries? Should the IMF become the dominant G7 institution for monitoring the Russian economy and dispensing official aid to it? The Bretton Woods institutions have played a useful role in promoting the growth of the private sector in the developing countries, through specialist institutions such as the International Financial Corporation, and in promoting market-oriented economic adjustment programs, but they have not yet examined the full implications for their future agenda of the private-sector boom now occurring in the developing countries.

When the World Bank and other development organizations were launched in the aftermath of Bretton Woods, their primary goal was to promote economic development, not eliminate poverty. It was widely expected that promoting development would help to set the stage for self-reinforcing economic take-offs which would bolster everyone's incomes. In some countries, economic take-off has occurred and real incomes have expanded significantly for practically all citizens. But many countries have failed to achieve economic take-off, while there are large pockets of poverty even in countries which have enjoyed several years of high GDP growth. The publicly available data for official aid programs suggests that, despite the improved access to private capital flows for the upper-income developing countries, spending on the world's poorest people has lagged badly during recent years. According to a recent survey of official lending programs in the *Economist* magazine, the richest 40 per cent of the developing world gets about twice as much aid per head as the poorest 40 per cent. The *Economist* reported:

> The naive taxpayer might imagine that aid's main purpose was to relieve poverty. Yet only relatively small amounts of ODA go to the poorest of

> countries or to projects that benefit mainly the poorest of people. A study of America's aid programme conducted by the Overseas Development Council (ODC), a Washington, DC, think-tank, found that more than $250 per person went to relatively high-income countries, but less than $1 per person to very low-income countries. Mahbub ul Haq of the United Nations Development Programme (UNDP), a fierce critic of aid's failure to reach the poorest, points out that the ten countries that are home to two-thirds of world's poorest people receive only one-third of the world aid.
>
> Within poor countries, too, aid is rarely concentrated on the services that benefit the poorest. The World Bank reckons that, of all the aid going to low-income countries in 1988, a mere 2% went on primary health care and 1% on population programmes. Even the aid that is spend on health and education tends to go to services that benefit disproportionately the better-off. Aid for health care goes disproportionately to hospitals (in 1988–89, for instance, 33% of Japan's bilateral aid for health went on building hospitals); aid for education, to universities. In sub-Saharan Africa in the 1980s, only $1 of ODA went to each primary pupil; $11 on each seconday pupil; and $575 on each university student.

In addition to poverty, there are major institutional bottlenecks still lingering in many of the developing countries which have recently regained access to the private financial markets. The Latin American nations, for example, have implemented only the first stage of the economic reforms which will be needed to establish viable market economies with stable political systems. In stage one, they were able, through Presidential decrees, to promote liberalization of trade and capital flows as well as sales of public-sector assets. They still have to upgrade their bureaucracies, modernize their public services, establish fair judicial systems, raise educational standards and pursue other administrative reforms to sustain popular support for economic liberalization. As foreign investors recognize that massive social inequality ultimately creates political instability, they also will become increasingly conscious of whether or not countries are able to follow up on the first round of administrative reforms with the broad-based administrative restructuring needed to curtail corruption, boost government productivity and satisfy social needs. Marxism may be discredited ideology but, as the recent financial crisis in Venezuela demonstrated, populism can easily be revived in countries which permit the process of economic take-off to produce large income gains for only a small share of the population, while leaving the public sector in the fiscal squalor and corruption which has characterized much of the modern era.

The challenge facing the Bretton Woods institutions is to develop program niches which complement the privatization boom now overtaking the development process in many countries. The African continent will continue to need both official financial assistance and far-reaching policy supervision for at least another generation. The Latin American countries have far more unequal income distribution and much less effective public-sector institutions than the successful developing countries of East Asia. The countries of the former Soviet Union will require varying mixtures of official foreign assistance and policy supervision to complete their transformation into market-oriented economic systems. The liberal revolution in economic and political ideas which swept the Third World during the late 1980s has so far by-passed most of the Islamic countries and has thus created a void which could be filled, in part, by international development institutions.

What should distinguish the role of the Bretton Woods institutions in the post Cold War era from the past half century is a more explicit recognition that under the correct policies the private marketplace can play a far larger role in the development process than was commonly believed ten years ago. As a result, their ultimate goal should be to set in motion a process of economic and political development which steadily diminishes the need for their existence.

THE RISKS TO DEVELOPING-COUNTRY EQUITY MARKETS

Some analysts have suggested that the recent upsurge of capital flows to the developing country stock markets is only a bubble and that investors will ultimately experience as unhappy an outcome as did the US banks who made loans to Latin America during the 1970s. As there were speculative booms in securitized lending to Latin America during the nineteenth century and the 1920s which ended in widespread defaults, it is not hard to construct scenarios in which the current investment boomlet also produces new credit problems or balance of payment crises. But the outcome will depend upon a variety of developments which are still unfolding in both the old industrial countries and the emerging market economies.

The external threats to the developing country markets will center on monetary developments and trade policy in the old industrial countries. During the late nineteenth century, most of the major slumps in US equity and bond prices resulted from fluctuations in the flow of capital from London to New York stemming from either crises in London (1873, 1890) or a loss of confidence in US economic policy (1893). The developing countries now dependent upon securitized money flows to their stock and bond markets could easily experience similar volatility in capital flows in the future. Much of the recent upsurge in capital flows to developing country security markets has occurred against a backdrop of low or falling interest rates in the UK, Europe and Japan. As with the nineteenth-century British investors who purchased American railway bonds, investors in the old industrial countries have been hungry for both higher yield vehicles in the new countries as well as opportunities for portfolio diversification. When the Federal Reserve hiked US interest rates during February 1994 there was an immediate correction in several of the Asian and Latin American stock markets which had benefited from large US investment flows during 1993. But, as the Fed appears likely to pursue only a gradualist monetary tightening during 1994, it is unlikely to reverse or even stop the capital flows to the new markets. The major risk to these markets will occur when and if US interest rates return to the 6–8 per cent range because of rising inflation. In such a scenario, some developing country markets dependent upon commodity production should benefit from higher export prices but others would suffer from the impact of rising interest rates on both capital flows and reduced growth prospects for non-commodity exports. In the nineteenth century and early twentieth centuries, most developing country stock markets were in countries which derived more than half of their foreign trade from exports of agricultural commodities or minerals. But, in the 1990s, there are far more divergences in the export mix of the developing countries. Non-fuel primary products account for 65 per cent of the exports of Argentina, 84 per cent of Chile's, 40 per cent of Columbia's, 72 per cent of Peru's, 70 per cent of South Africa's and 20 per cent of Indonesia's. Fuel exports accounts for 29 per cent of Columbia's exports, 81 per cent of Venezuela's and 33 per cent of Indonesia's. In Hong Kong, Singapore and other East Asian nations, by contrast, manufactured goods dominate export trade, and ratios of manufacturing output to GDP are often far higher than in the USA and Europe. If the next world economic recovery produces a resurgence of commodity price inflation, the stock markets of Latin America and Africa will probably out-perform many East Asian markets. But when monetary policy is tightened to reduce inflation and commodity prices slump, East Asia will clearly benefit from her dependence upon manufacturing exports and the greater financial autonomy which results from her high savings rate.

As a result of trade's role as a growth locomotive in many developing countries, the equity markets of these countries will always be very sensitive to changes in G7 trade policy. In 1993, there were numerous occasions when the dominant event in the Latin American markets was investor perceptions of the outlook for the North American Free Trade Agreement and the GATT. If NAFTA had been defeated there would have been an immediate crisis in Mexico's financial markets and the government would have probably been forced to accept a peso devaluation. Although it would have been more difficult for the financial markets to single out individual winners or losers from a GATT defeat, there is no doubt that developing country equity markets would have suffered from investor concern about an upsurge of global protectionism. Conversely, the successful outcome to both the NAFTA and GATT debates gave a major boost to equity markets all over the world during the final months of 1993. The new trade agreements suggested that world trade would continue to expand at a rate in excess of OECD GDP and thus provide a growth locomotive for the newly emerging market economies. Investors also believe that free trade will help to restrain inflation in the old industrial countries.

The major internal risks to the stock market boomlet in the developing countries center on economic and social policy. Will liberal economic policies produce a sufficiently broad-based distribution of wealth to maintain social stability or will the benefits of rapid economic growth accrue to only a few people? In Mexico, for example, three months after the enactment of NAFTA, the stock market has slumped because of investor apprehension about the August presidential election. During the past decade, there has been a sharp decline in Mexico's wage share of GDP, while the movement towards free trade has produced large job losses in the manufacturing sector and now threatens to displace millions of peasant farmers. These grievances, coupled with the Indian uprising in Chiapas in January and the assassination of the PRI presidential candidate in March, have forced investors to re-examine their assumptions about the social and political risks involved in Mexico's rapid economic transition. While there is widespread investor confidence that the next Mexican President will sustain the Salinas reforms, the markets are demanding higher political risk premiums during the short term because there have been so many negative surprises this year. The emerging markets will also be vulnerable to investor concern about traditional economic disequilibria, such as high inflation or large current account deficits. In 1993, for example, the Turkish stock market had tripled because of investor optimism about the country's economic modernization and attempts to integrate it more closely with Europe. But in early 1994 the Istanbul market suddenly lost half of its value because the persistence of large budget deficits and high inflation prompted international rating agencies to lower the national credit rating. The abrupt collapse of the Turkish market encouraged some pundits to suggest that an emerging market should be classified as "a market from which one cannot emerge during an emergency". Liquidity is often a problem in the developing country equity markets because of a heavy concentration of share ownership among a few investors, the absence of large institutional investors with stable cash flows, and the foreign investor's lack of familiarity with local trading practices.

It also remains to be seen if volatility in capital flows to the emerging markets will become a political issue in the developing countries themselves. During the peso crisis which followed the Colosio assassination, for example, Mexican officials had numerous conference calls and meetings with US mutual fund groups owning large investments in peso-denominated assets. The fund managers proposed various policy adjustments in order to help stabilize the peso, and the Mexican authorities implemented many of them. If the peso remains stable and capital flows to Mexico resume, the whole episode will be remembered as a temporary interlude in Mexico's continuing evolution as an open economy. But if US mutual funds suffer large redemptions because of rising interest rates in the future, they might be forced to sell Mexican paper, despite the fact that the Mexican government has attempted to follow through on their policy suggestions. In such a scenario, critics of the government might allege that Mexico had become overly dependent upon hot money flows from US mutual funds and that the peso should be permitted to decline in order to bolster competitiveness and reduce the trade deficit. If the peso did fall sharply, American mutual fund groups might then be slow to return to the Mexican marketplace and thus force Mexican real interest rates to remain at high levels indefinitely. The commercial banks, by contrast, did not have to worry about deposit withdrawals forcing them to liquidate their Mexican loan portfolios. They adjusted the interest rates on their loans up and down in response to market conditions but their source of funding was not as unpredictable as the money flows of the mutual fund industry during periods of monetary tightening. In the USA during the late nineteenth century, there was widespread hostility to British financial interests among groups with favored a dollar devaluation in order to boost farm prices. They alleged that the Congress had returned to the gold standard and was thus supporting deflation because of bribes from British financiers who owned US bonds. No Mexican business group or politician has yet alleged that the Mexican government is maintaining an overvalued peso and high real interest rates in order to protect the owners of American global money markets funds but such complaints could surface if the Mexican economy remains caught in recession because of peso overvaluation, rising US interest rates and reduced savings flows to the mutual fund industry.

The development of effective stock market regulatory institutions and standards of information disclosure also will become a progressively more important influence on the valuation of both developing country stock markets and individual sectors within the markets. International investment organizations are acutely sensitive to factors such as their ability to obtain information on a timely, accurate basis and to do so on a level playing field compared with local investors. International investors tend to place a higher valuation on companies which are perceived to have superior quality of disclosure and to severely penalize those which are perceived to be deficient in this area. In Indonesia, for example, there was a sharp rise in the value of practically all new companies when the Jakarta stock market first began to emerge during 1989 and 1990. But by 1991 it was increasingly apparent that many companies would not be able to satisfy their earnings projections at the time of the initial public offering. As a result, a triple tier stock market developed, in which the highest valuations were given to the local affiliates of foreign multinationals (say Unilever), the second highest valuation was given to domestic companies which satisfied their initial earnings projections, and the lowest multiples were conferred upon companies which failed to achieve their forecasts or adequately inform analysts about why they had not done so. Since 1991, standards of disclosure in Indonesia have improved and some of the valuation extremes have diminished as the market itself rallied. But the Indonesian experience of 1991–2 still serves as a useful example of the valuation divergences which can emerge on the basis of differential disclosure standards.

CONCLUSION

The rapid growth of developing country stock and bond markets since 1989 is helping to restore the volume of international private capital flows to levels previously experienced during the half century before the First World War. It is a phenomenon resulting from the rebirth of liberal economic ideas in many developing countries, the expanded role of securitized forms of financial intermediation everywhere and a search for higher asset returns by investors in the mature industrial countries. As a result of the explosive growth occurring in private capital flows and the fiscal crises constraining the governments of many industrial countries, the private sector will play a far more dominant role in shaping the contours of the post Cold War economy than it did during the years immediately after Bretton Woods. The G7 governments will play a major role providing frameworks for regulating trade and investment as well as helping their domestic workers adjust to the price shocks resulting from increased international competition, but they are unlikely to favor the restoration of a fixed exchange rate system or the creation of new global financial institutions comparable to those launched at Bretton Woods in 1944.

At present, the thirty largest emerging markets have a capitalization of about $2 trillion compared with $11 trillion for the old industrial countries. But as the developing countries account for over 75 per cent of world population and 40 per cent of real world output, while having growth rates potentially two or three times as high as the old industrial countries, their markets are likely to expand far more rapidly during the next ten years. By the year 2000, the so-called emerging markets could have a capitalization exceeding 25 per cent of the world total, compared with 15 per cent (including Hong Kong and Singapore) today. But the term "emerging market" is itself a transitional concept and likely to disappear some time during the next ten years. Instead, investors will probably use new concepts such as "high growth-middle income," "high income-mature," or "low growth-low income" to categorize global stock markets in the year 2000. They also will make distinctions between the different forms of capitalism now emerging in the post-communist world, as some of the countries will follow the Anglo-Saxon model of stock-market-driven corporate development while others will follow the universal banking/corporate cross share-holding models of Japan and continental Europe. But even these distinctions will be difficult to apply because of the increasing focus of multinational companies listed in New York, Tokyo, London and other centers in new, high-growth regions such as Latin America and Asia. Investors are increasingly turning to consumer brand and capital goods companies listed in these markets, not just companies actually listed on the stock exchanges of the developing countries, as a way to play the growth of the emerging market economies. Such a blurring of geographic and sectoral concepts provides further confirmation that the 1990s will be remembered ultimately not only as the era of emerging markets but as the decade in which the capitalist economic system was restored to its pre-1914 global frontiers.

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6

DOLLAR AND YEN

The problem of financial adjustment between the United States and Japan

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ABSTRACT

Must the yen continually appreciate against the dollar to better balance international payments between Japan and the United States? During the 1950s and 1960s, when the yen/dollar exchange rate was fixed, adjustment took place quite smoothly because Japanese monetary policy was naturally expansionary. Under floating exchange rates after 1973, the chronic tendency of the yen to appreciate—at American urging—has forced the Bank of Japan into a relatively deflationary monetary policy, with recent periods of severe overvaluation and depression—and with no reduction in Japan's current-account surplus. Nor can the USA afford such a reduction. The US economy is now dependent on Japanese saving, as illustrated by the American "credit crunch" of 1991, when long-term capital outflows from Japan (and Germany) to the USA suddenly dried up. This paper shows how the yen/dollar rate can be stabilized by harmonizing monetary policies so as to reduce financial volatility in both countries.

How does the arcane subject of the yen/dollar exchange rate affect growth and development into the twenty-first century? At first glance, the balance of payments problem between Japan and the United States seems to be one of securing proper short-term financial adjustment between the two countries and rather less one of determining longer-term productivity growth, saving and capital accumulation.

However, getting the yen/dollar exchange rate right by harmonizing American and Japanese monetary policies raises two important long-term issues. The first is whether mutual adjustment to ongoing, but differential, productivity growth in the two countries can proceed with minimum friction—i.e., without unnecessary losses in output through protectionism or cyclical downturns. The second is whether or not, given the savings shortage in the United States and Japan's emergence as the dominant creditor country in the world economy, saving can be efficiently transferred from one country to the other. Unfortunately, the current regime, where the yen has been appreciating erratically for well over two decades, satisfies neither criterion.

In this paper, I argue against using the exchange rate as an instrumental variable to "correct" current-account imbalances or equalize international competitiveness. From 1971, when a dollar was worth 360 yen, until July 1994, when it dipped to 98 yen, the efforts of the American government to "talk" or otherwise force the yen up and the dollar down have harmed both countries. While failing to correct trade imbalances, for reasons I will explain, continual yen appreciation has induced episodes of severe wage-price misalignments between the two countries, leading to unnecessary cyclical instability and losses in real output in the short run.

In the longer run, the ever-higher yen has undermined the natural wage-adjustment process for balancing international competitiveness. In the 1950s and 1960s, when the exchange rate was fixed at 360 yen to the dollar, each country's money wages grew in conformity with its (differential) growth in manufacturing productivity—much faster in Japan than in the United States. Subsequently, the ever-higher yen has imposed relative deflation on Japan. Growth in money wages in Japan has slowed dramatically and is now slower than money wage growth in the United States, despite the fact that long-term productivity growth in Japanese manufacturing remains relatively high.

A related problem in the 1980s into the 1990s is the capital shortage in the United States. Large fiscal deficits and low private saving virtually require the United States to run a current-account deficit in trade in goods and services of the same order of magnitude. Without net inflows of foreign capital, as measured by its current account deficit, the American economy would suffer from a credit crunch and economic slowdown such as that experienced in 1990–2, when the American current-account deficit was suddenly reduced. Correspondingly, American pressure on the Japanese to engage in a Keynesian style fiscal "expansion"—i.e. reduced saving through larger fiscal deficits—is also inappropriate. Unlike yen appreciation, lower Japanese saving would indeed reduce Japan's trade surplus, but it would also harm the United States and other (potential) debtor countries in the world economy.

The near-term adjustment problem—the overvalued yen, the 1992–4 slump in the Japanese economy, the current-account deficit, and incipient capital shortage of the United States—will be tackled later in the paper. First, however, consider a longer-term view of financial adjustment between Japan and the United States. How has the yen-dollar exchange rate been linked to the past evolution of prices and wages in each country, and how should they be linked in the future?

1951 = 100

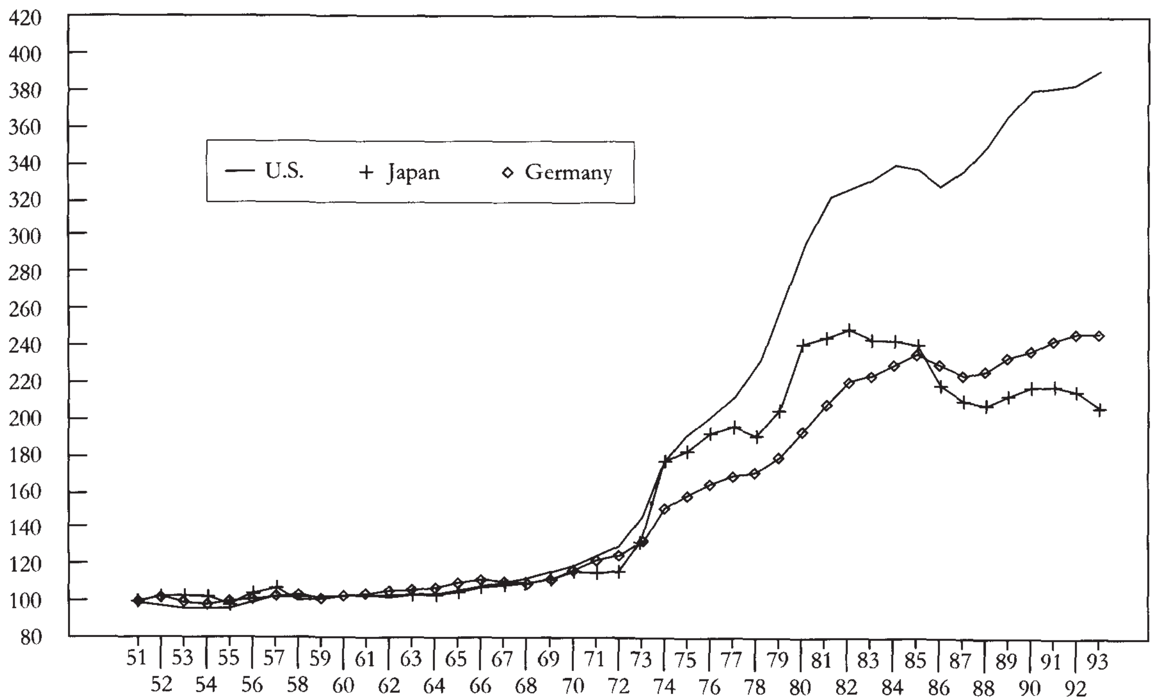

Figure 6.1 Wholesale price levels

WAGE AND PRICE ADJUSTMENT UNDER THE FIXED-RATE DOLLAR STANDARD, 1950–70

In retrospect, the years from 1950 to 1970 were the most harmonious in Japanese—American financial history. Under the fixed-rate dollar standard, the Bank of Japan geared its domestic monetary policy to keeping the exchange rate at 360 yen per dollar, while the US Federal Reserve anchored the common price level for tradable goods. Until the end of the period, inflation in both countries' wholesale price indices was confined to about 1

Table 6.1 Real output: Japan and the United States, 1951–93 (annual averages, 1990=100)

Year	*Industrial production*		*GDP[2] USA*	*GNP[3] Japan*
	USA	*Japan*		
1951	25.3	3.9	1,764.4	372.8[1]
1961	34.6	15.2	2,293.3	771.5
1970	55.4	45.3	3,256.0	1,822.3
1971	56.1	46.5	3,357.0	1,901.5
Change 1951–71	**122%**	**1,092%**	**90.3%**	**453%**
Annual	4.0%	12.4%	3.2%	8.5%
1972	61.6	49.8	3,517.8	2,060.8
1982	72.7	68.7	4,257.3	3,032.7
1983	77.0	70.7	4,423.0	3,117.3
1984	85.7	77.4	4,696.8	3,252.2
1985	87.4	80.3	4,845.5	3,420.6
1986	88.3	80.1	4,986.7	3,510.9
1987	91.6	82.8	5,140.1	3,663.2
1988	96.5	90.8	5,342.3	3,891.8
1989	99.0	96.1	5,477.6	4,079.3
1990	100.0	100.0	5,522.2	4,274.7
1991	98.1	101.8	5,458.3	4,457.4
1992	99.6	95.6	5,645.4	4,518.0
1993	101.7	91.2	5,811.1	4,523.1
Change 1972–92	**61.7%**	**92.0%**	**60.5%**	**119%**
Annual	2.4%	3.3%	2.4%	3.9%
Change 1982–92	**37.0%**	**39.2%**	**32.6%**	**49.0%**
Annual	3.1%	3.3%	2.8%	4.0%
1992–3	2.1%	−4.6%	2.9%	0.1%

Source: IMF *International Financial Statistics*, CD-ROM, June 1994. [1]1952 was earliest available data, so the percentage change was calculated from 1952 to 1972. [2]Billions of US dollars with 1990 as the base year. [3]100 billions of yen with 1990 as the base year.

per cent per year (see Table 6.2)—a remarkable record of stability that subsequently gave way to floating exchange rates and the great inflations of the 1970s (see Figure 6.1). In the 1950s and 1960s, however, protectionist barriers came down and trade between the two countries grew rapidly. Fiscal and current-account imbalances remained comparatively modest. From financial stability came the postwar era of rapid economic growth. From 1951 to 1971, Japan's real GNP grew at an amazing 8.5 per cent per year; and, starting from a much higher absolute level, US real GDP grew at a robust 3.2 per cent per year (see Table 6.1). From the 1950s to the early 1970s, economic growth in the United States, Japan and other industrial countries was generally higher—with minimal inflation—than that seen before or since (Madison 1989).

Then, more than now, the pace of growth varied across countries and industries (Ohno 1993). Starting from much lower absolute levels in 1951, Japanese industrial output grew more than three times as fast as that in America until the early 1970s (Table 6.1). With the exchange rate fixed and Japan[2] retaining exchange controls on capital flows, how then did the balance of payments adjust?

First, in tradable goods sectors, secular adjustments in average money wages more or less accurately offset this differential growth in average productivity. From 1951 to 1971, money wages in Japan grew by 331 per cent, compared with just 114 per cent in the United States (Table 6.2). On an annual basis, the IMF data in Table 6.2 show monthly earnings in Japanese manufacturing grew about 3.4 percentage points faster than hourly wages in US manufacturing—7.6 per cent versus 4.2 per cent. But inflation in tradable goods prices was virtually the same in both countries: the US wholesale price index increased annually by 1.1 per cent and the Japanese by 0.7 per cent in the same twenty-year period of unmatched worldwide growth (Table 6.2). Because Japanese money wages grew much faster than their American counterparts, balanced international competitiveness, in the sense of maintaining the alignment of national price levels at the "factory gate," was pretty well preserved in the 1950s and 1960s. (After 1968, however, excessive upward drift in US money wages nudged US wholesale price inflation above that in Japan and other industrial countries.)

Alternatively, more direct measures of labor productivity growth in the 1950s and 1960s might be compared to growth in money wages to determine whether or not relative wage adjustment was "sufficient" between the two countries. In a large-scale empirical study of fourteen Japanese manufacturing industries at the SITC two-digit level, Kenichi Ohno (1993) estimates that Japanese labor productivity in manufacturing from 1952 to 1971 grew about 7.6 per cent per year—with enormous differences from this average for individual industries as shown in Table 6.3. Ohno also estimated that hourly wages in manufacturing increased at 9.2 per cent per year—thus, apparently, *Table* 6.2 Prices, money wages and exchange rates: Japan and the United States, 1951–93 (annual averages, 1985=100)

Year	*Wholesale prices*		*Money wages*[1]		*Consumer prices*		*Yen/dollar exchange rate*
	USA	*Japan*	*USA*	*Japan*	*USA*	*Japan*	
1951	29.5	41.6	16.4	6.4	24.1	16.6	360
1961	30.6	43.2	24.4	10.3	27.8	22.3	360
1970	35.7	48.6	35.2	24.0	36.1	36.9	360
1971	36.9	48.2	37.4	27.6	37.6	39.3	349
Change							
1951–71	**25.1%**	**15.9%**	**128%**	**331%**	**56.0%**	**137%**	**−3%**
Annual	1.1%	0.7%	4.2%	7.6%	2.2%	4.4%	–
1972	38.6	48.6	39.9	31.9	38.9	41.2	303
1982	96.9	103.7	89.1	90.8	89.7	94.1	249
1983	98.1	101.4	92.6	93.7	92.6	95.8	238
1984	100.5	101.1	96.3	96.9	96.6	98.0	238
1985	100.0	100.0	100.0	100.0	100.0	100.0	239
1986	97.1	90.0	102.1	102.9	101.9	100.6	169
1987	99.7	87.5	103.9	105.0	105.7	100.7	145
1988	103.7	86.6	106.7	108.6	109.9	101.4	128
1989	108.8	88.8	109.8	112.1	115.2	103.7	138
1990	112.7	90.6	113.6	116.3	121.4	106.9	145
1991	112.9	90.8	117.3	120.3	126.6	110.4	135
1992	113.6	89.5	120.4	122.9	130.4	112.3	127
1993	115.3	86.1	123.2	125.4	134.3	113.7	111
Change							
1972–92	**194%**	**84.2%**	**202%**	**285%**	**235%**	**173%**	**−58.1%**
Annual	5.5%	3.1%	5.7%	7.0%	6.2%	5.1%	−4.3%
Change							
1982–92	**17.2%**	**−13.7%**	**35.1%**	**35.4%**	**45.4%**	**19.3%**	**−51.0%**
Annual	1.6%	−1.4%	3.1%	3.1%	3.8%	1.8%	−6.5%
1992–3	1.5%	−3.8%	2.6%	2.0%	3.0%	1.2%	−12.6%

Source: IMF *International Financial Statistics:* CD-ROM, June 1994.
[1] Monthly earnings in Japan and hourly earnings in manufacturing in the US.

overadjusting to absolute productivity growth. Because of a shortening work-week in Japan in this period, hourly wages (Table 6.3) apparently grew somewhat faster than the 7.6 per cent growth in monthly earnings recorded in Table 6.2. But with the Japanese WPI rising only slightly from 1951 to 1971, "overadjustment" in Japanese wages at most would be slight. (Because of the particularly rapid introduction of new products in the 1950s and 1960s, output and productivity indices are inherently ambiguous.)

Table 6.3 Labor productivity and wages in manufacturing: Japan (average annual percentage increase)

	1952–71		*1972–90*	
	Labor productivity	*Wages*	*Labor productivity*	*Wages*
All manufacturing	**7.6**	**9.4**	**4.3**	**7.4**
Food	3.4	9.2	1.6	6.3
Textiles	8.4	10.2	4.2	7.1
Wood	0.3	10.6	1.7	7.5
Paper	8.1	7.8	2.6	7.1
Chemical	11.1	9.8	4.8	7.8
Oil & coal	11.0	9.9	1.5	8.3
Ceramics & stone	6.6	9.1	2.1	7.5
Iron & steel	9.2	9.3	4.0	7.4
Nonferrous metals	6.5	N/A	1.9	7.3
Metal products	6.3	9.6	3.5	7.4
General machinery	8.3	9.7	5.8	7.5
Electrical mach.	10.1	8.1	9.0	7.5
Transport mach.	12.4	8.9	7.2	7.5
Precision mach.	9.6	8.7	6.9	7.5
Standard deviation	**3.1**	**0.8**[1]	**2.3**	**0.4**

[1] Excluding nonferrous metals.
Source: Japanese Ministries of Labor (employment and wages) and International Trade and Industry (production in current prices), and Bank of Japan (prices). Labor productivity is derived from employment, production, and price data. Compiled by Kenichi Ohno.

Starting from a much higher absolute level in 1951, American labor productivity in manufacturing grew about 2.4 per cent annually from 1952 to 1971 (Table 6.4)—about 5 percentage points less than shown in Ohno's data for Japan. However, the US Bureau of Labor Statistics also shows that American hourly wages grew more slowly—about 4.8 per cent, compared with Ohno's estimates of 9.2 per cent for Japan—a difference of about 4.4 percentage points that almost offset the gap in productivity growth when the exchange rate was fixed at 360 yen/dollar. *Within the bounds of measurement error, differential adjustment in average money wages between Japan and the United States in the 1950s and 1960s was sufficient to balance international competitiveness between the two countries.*

In addition to adjustment in relative money wages across countries, the

Table 6.4 Labor productivity and wages in manufacturing: United States (average annual percentage increase)

	1952–71		*1972–90*	
	Labor productivity	*Wages*[1]	*Labor productivity*	*Wages*[1]
All manufacturing	**2.4**	**4.8**	**2.3**	**6.7**

Source: US Bureau of Labor Statistics, *Handbook,* 1989 and *Employment and Earnings* (various issues).[1] Hourly compensation including wages plus other employer contributions.

absence of substantial saving-investment gaps within the Japanese or American economies further helped balance international payments in the 1950s and 1960s. Unlike the period to come, the US Federal Government did not run significant fiscal deficits: it behaved as if it had a hard budget

Table 6.5 Japanese-American trade and current account balances, and the US Federal fiscal deficit: 1956–93 (Billions of US dollars)

Year	*Trade balance*		*Current account*		*US fiscal surplus*[1]
	USA	*Japan*	*USA*	*Japan*	
1956	4.57	−0.12	1.57	−0.03	4.5
1957	6.10	−0.39	3.41	−0.61	1.2
1958	3.31	0.38	−0.13	0.28	−7.2
1959	0.99	0.36	−2.28	0.35	−7.9
1960	4.89	0.27	2.82	0.14	0.3
1961	5.57	−0.56	3.82	−0.98	−3.5
1962	4.52	−0.40	3.38	−0.04	−7.2
1963	5.22	−0.16	4.40	−0.77	−4.8
1964	6.80	−0.37	6.82	−0.48	−5.9
1965	4.95	1.90	5.41	0.92	−1.6
1966	3.82	2.27	3.03	1.25	−3.8
1967	3.80	1.16	2.59	−0.18	−8.7
1968	0.64	2.53	0.59	1.03	−15.2
1969	0.60	3.69	0.42	2.12	5.4
1970	2.59	3.96	2.33	1.99	−11.4
1971	−2.27	7.76	−1.45	5.80	−24.8
1972	−6.42	8.94	−5.78	6.64	−18.7
1973	0.91	3.64	7.07	−0.13	−16.2
1974	−5.51	1.35	1.94	−4.72	−4.5
1975	8.90	4.94	18.06	−0.68	−53.9
1976	−9.47	9.80	4.18	3.71	−74.9
1977	−31.11	17.16	−14.49	10.91	−52.2
1978	−33.94	24.30	−15.40	16.54	−58.9
1979	−27.54	1.74	0.20	−8.74	−36.0
1980	−25.51	2.13	2.25	−10.75	−76.2
1981	−28.02	19.96	5.05	4.77	−78.7
1982	−36.48	18.08	−11.42	6.85	−125.7
1983	−67.09	31.46	−43.65	20.80	−202.5
1984	−112.48	44.26	−98.78	35.00	−178.3
1985	−122.18	55.99	−121.79	49.17	−212.1
1986	−145.06	92.82	−147.54	85.83	−212.6
1987	−159.56	96.42	−163.45	87.02	−147.5
1988	−126.96	95.00	−126.67	79.61	−155.5
1989	−155.68	76.89	−101.19	56.99	−143.8
1990	−108.84	63.58	−90.46	35.87	−218.1
1991	−73.44	103.09	−3.69	72.91	−272.5
1992	−96.28	132.40	−62.47	117.64	−289.3
1993	−132.5	141.40	−109.24	131.35	−281.1

Source: IMF *International Financial Statistics:* CD-ROM, June 1994 [1]Federal Government.

constraint.[3] The right-hand column in Table 6.5 shows that the dollar values of US fiscal deficits were modest—and were even punctuated by the occasional surplus. Table 6.5 also shows that, for the 1950s and 1960s, the USA always ran trade surpluses and usually ran current-account surpluses: there was no heavy net borrowing from the rest of the world. The USA was a major creditor in world capital markets.

Even when its per capita income was low, Japan was not a major borrower. In the 1950s and 1960s, Japan alternated between small current-account surpluses or deficits. Any substantial change in the balance between private saving and private investment was offset by an opposite change in the government's net financial saving position (Bayoumi 1990). Because exchange controls on capital flows made the private financing of any large current-account imbalances next to impossible, governments in the industrial countries oriented their fiscal policies more toward balancing their current accounts.

Accommodating monetary policy in Japan

For relative wages to adjust so well, Japanese monetary policy had to be expansionary. Although Japan's tradable goods prices—as measured by the WPI—were well anchored by the fixed exchange rate (see Figure 6.1), consumer prices increased relatively fast. Because Japanese productivity growth was much less in services than in manufacturing, even as wages in both sectors rose equally fast (Ohno 1993), the cost of non-tradable services rose sharply.[4] Table 6.2 shows that, from 1951 to 1971, Japan's CPI increased by 137 per cent, whereas the American CPI only increased by 56 per cent. If the Japanese monetary authorities had focused on stabilizing the CPI rather than on the dollar exchange rate and WPI, Japan's money wage growth would have had to be much slower, with the yen continually appreciating against the dollar in order to keep tradable goods prices—i.e., WPIs—approximately aligned between the two countries.

To assess further how relatively expansionary monetary policy in Japan actually was, Table 6.6 compares rates of growth in "narrow" money in each country to growth in their nominal GNPs from 1955 to the present. Changes in the velocity of money are notoriously difficult to interpret—although they were perhaps less so in the 1950s and 1960s, when inflationary expectations (in goods prices) were minimal. Nevertheless, from 1955 to 1971, the stock of narrow money in yen grew significantly faster than even the rapid growth in Japanese nominal GNP—15.5 per cent versus 14.1 per cent respectively on an annual basis. In the more financially mature American economy, where the US Federal Reserve System effectively anchored the common price level in both countries, the opposite was true. From 1955 to 1971, American narrow money grew more slowly than American nominal GNP—3.5 per cent versus 6.3 per cent (see Table 6.4), and much more slowly than money growth in Japan.

Table 6.6 Growth in narrow money and nominal GNP: Japan and the United States, 1955–93 (annual percentage changes)

Year	*United States*		*Japan*	
	Money	*GNP*	*Money*	*GNP*
1955–71	3.46	6.24	15.47	14.13
1972–82	6.33	9.62	8.85	7.48
1983–93	7.20	6.19	5.88	5.17

Source: IMF *International Financial Statistics:* CD-ROM, June 1994. Narrow money is defined by line 34 of IFS.

From both perspectives—higher internal CPI inflation as well as higher money growth—Japanese monetary policy was indeed relatively expansionary compared to that pursued by the United States during the era of fixed exchange rates and very high real growth.

Japan's relatively expansionary monetary policy arose naturally out of its obligation to fix the exchange rate within a narrow 2 per cent band. The Japanese authorities did not base their monetary policy on immediate domestic considerations. If a balance of payments surplus appeared, the Bank of Japan tended to expand domestic credit—and vice versa for a balance of payments deficit. Rather than using foreign exchange interventions themselves as the principal technique for altering the domestic monetary base, however, the Bank of Japan preferred—at least until 1968—to keep foreign exchange reserves fairly small and constant by varying domestic credit availability to offset (incipient) changes in the balance of payments.

In summary, the 1950s and 1960s did have adjustment problems but they were more micro than macro in nature. Because the pace of productivity growth across individual Japanese industries was uneven (see Table 6.3 and Ohno 1993), some US industries lost worldwide market share to Japanese competitors uncomfortably fast. But overall macroeconomic adjustment, where differential growth in average productivity between the USA and Japan was offset by higher money wage growth in Japan, worked smoothly. Payments imbalances and producer price-level misalignments, which loomed so large in the years after the par-value system for exchange rates broke down, were comparatively minor.

DOLLAR DEVALUATIONS AND FORCED RELATIVE DEFLATION IN JAPAN: THE BREAKDOWN OF WAGE ADJUSTMENT, 1972–93

Beginning in 1968, US wages began to increase a bit too fast to keep the American WPI stable, and to offset the gap in productivity growth with Japan. In contrast to the 1 per cent annual growth observed from 1951 to

1967, American wholesale prices began rising about 3.5 per cent per year from 1968 to 1971. The American nominal anchor, and the economic rationale, for the fixed-rate dollar standard began to slip. Economists in Europe, Japan and the United States began to advocate more flexibility in exchange rates (McKinnon 1993). And, on the American side, exchange rate flexibility meant dollar devaluation.

When President Nixon shut the gold window in August 1971 and imposed a temporary import surcharge to enforce his demand that the dollar be officially devalued against the yen and other important currencies (as it was by the following December), he was following conventional economic wisdom. Most of his economic advisers—whether monetarist or Keynesian—applauded the transformation of the heretofore rigid exchange rate into an "adjusting" variable. Subsequently, US Secretaries of the Treasury have not hesitated to attempt to talk the dollar down publicly—Blumenthal in 1977, Baker in 1985–7 and Bentsen in early 1993, to take some of the better-known examples. Except for the brief period of the overly strong dollar in the early 1980s, this process continued in economic "summits" and other less formal channels.

And the dollar has indeed fallen—albeit on an extremely erratic path (see Figure 2). Over the past twenty-three years, the dollar fell from 360 yen and 3.7 marks in 1970 to about 98 yen and 1.53 marks in July 1994. Has this exchange rate flexibility—i.e., continual dollar devaluation—made the international adjustment mechanism more efficient?

I shall argue that American pressure on trading partners to depreciate the dollar has undermined the wage adjustment mechanism that had prevailed in the 1950s and 1960s. Because greater price and wage inflation was induced in the United States itself with corresponding deflationary pressure in Japan, relative growth in money wages after 1971 no longer reflected differences in productivity growth across the two countries. In addition, a flexible exchange rate is also, naturally, an untethered exchange rate: a new source of net financial volatility in the world economy, as with the yen's current sharp overvaluation.

Before considering the current overvaluation of the yen, however, Table 6.2 shows the price-wage exchange rate experience for both countries from 1972 to 1993. Two facts stand out:

1 Without a stable US anchor for the world price level, average price inflation (WPI) was higher in this twenty-year period, particularly in the 1970s, than it had been from 1951 to 1971.
2 From 1972 to 1993, Japan experienced price deflation *relative* to the US, measured by either the WPIs or CPIs.

In addition, Table 6.6 shows in more recent periods the even sharper slowdown in Japanese money growth relative to that of America.

Comparing Table 6.3 with Table 6.4, the gap by which wage growth in

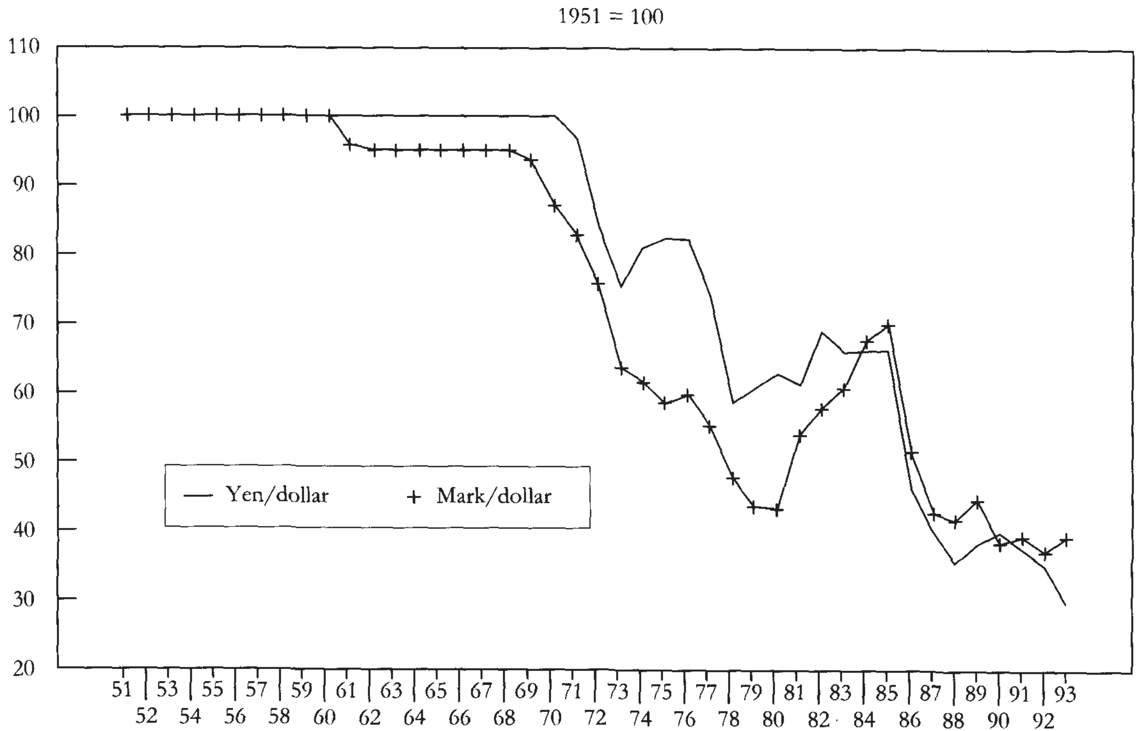

Figure 6.2 Exchange rates against the dollar

Japan exceeded that in the United States shrank from 4.6 percentage points over 1952–71 to 0.7 percentage points from 1972 to 1990. More recently, from 1982 to 1992, Table 6.2 shows that the pace of money wage growth was about the same, averaging 3.1 per cent per year in each country. Finally, taking the very last year from 1992 to 1993, Japanese money wage growth was *less* than that in the United States—2 per cent versus 2.6 per cent (Table 6.2). Into 1994, this trend toward absolutely lower growth in money wages in Japan vis-à-vis the United States continues (see *The Economist,* 1994:93). The old wage-adjustment mechanism of the 1950s and 1960s has been turned on its head!

The statistical story on the price side also shows rising relative inflation in the United States, as a glance at Table 6.2 and, more spectacularly, Figure 1 indicates. From 1951 to 1971, WPIs in both countries stayed close together, increasing about 1 per cent per year. From 1972 to 1992, the gap widened, with 5.5 per cent inflation in the US WPI compared with 3.1 per cent in Japan's. In the more recent decade from 1982 to 1992, the gap widened further: Table 6.2 shows the American WPI rising by 1.6 per cent per year and the Japanese WPI *falling* 1.4 per cent per year. Finally, from 1992 to 1993, US producer prices[6] rose by 1.5 per cent per year, while Japan's fell by 3.8 per cent. (Table 6.2 also shows that the one-year decline in the Japanese WPI in 1986 was actually greater during this earlier period of massive yen overvaluation.)

What caused this remarkable fall in the relative (and absolute) growth in Japanese money wages and prices? After all, long-term productivity growth in Japanese manufacturing remains substantially higher than in the United States—as shown in Tables 6.3 and 6.4. I shall distinguish two competing hypotheses for explaining the same data. Both revolve around the appropriate interpretation of the fall in the yen/dollar exchange rate from 1971 to now.

The first and more conventional hypothesis treats the exchange rate as a *passively adjusting variable*. Monetary policies in each country are determined independently, and the exchange rate then adjusts. The second hypothesis treats the exchange rate as a *forcing variable,* which itself has a first-order impact on relative monetary policies in the two countries. Let us consider each in turn.

Hypothesis I: the exchange rate as a passively adjusting variable

The relative deflationary pressure on Japanese prices since the early 1970s, as so vividly shown in Figure 6.1, is often explained in conventional monetarist terms. After the breakdown of the Bretton Woods system of par values in 1971 and, more particularly, after the further collapse of the short-lived Smithsonian par-value system in February 1973, Japan seemed finally free to choose its own monetary policy. No longer did Japan have to defend a dollar-based par-value system which had become very inflationary.[7] Under hypothesis I, the Bank of Japan chose independently to follow a less inflationary policy than the US Federal Reserve System. Table 6.6 shows the marked slowdown in Japanese money growth relative to the United States. Over 1955–71, annual narrow money growth in Japan was 15.5 per cent, versus only 3.5 per cent in the USA; over the period 1972–82, Japanese money growth slowed to 8.9 per cent, while that of America speeded up to 6.3 per cent; for the decade 1983–93, Japanese money growth became even *lower* than that of America—5.9 per cent versus 7.3 per cent.

Initially, the ostensible monetary independence of Japan under hypothesis I looked good. In the late 1970s and early 1980s, the appreciated yen (see Figure 6.2) succeeded in insulating Japan from the second great worldwide inflation (see Figure 6.1). This apparently independent choice of a relatively deflationary monetary-cum-exchange-rate policy kept Japan's price level much more stable than its American counterpart. Then, by letting its currency depreciate slightly, Japan could avoid following the sharp American disinflation of 1981–4. (The Reagan years from 1981–4 was the only period where the Americans were not continually pressuring the Japanese to appreciate.)

The objection to accepting hypothesis I, however, arises from its apparent inconsistency with the unduly sharp deflations in the Japanese WPI in 1986–7 and again in 1992–4. If the Bank of Japan's monetary policies were (are) truly independent, why would it choose to suddenly deflate in two situations when Japanese (and world—i.e., dollar) tradables prices were quite stable? Both deflationary episodes have been accompanied by severe industrial distress.

The aftermath of a sharp deflation can also cause difficulties. To get out of the 1986–7 deflation, the Bank of Japan reduced nominal interest rates so sharply that it set in motion the so-called bubble economy: the unsustainable bidding up of longer-term asset values. Anxious to stimulate domestic spending, the Japanese Ministry of Finance took further measures to encourage the bidding up of property and stock market values from 1987 to 1990 (Taniguchi 1993), thus setting the stage for the financial crash of 1991–2.

Contrary to hypothesis I, the short-run business-cycle costs of sharp yen appreciations in the mid–1980s and early 1990s have been so high that the Bank of Japan seems not to be following an independent monetary policy with a passively adjusting exchange rate. Is there an alternative way of explaining relative Japanese and American monetary experiences over the past twenty years?

Hypothesis II: the exchange rate as a forcing variable

Modern theory tells us that, in the absence of exchange controls on capital movements, the exchange rate is a forward-looking asset price (Frenkel and

Mussa 1980). Instead of adjusting passively to current or past price-level misalignments or trade imbalances, the spot exchange rate is determined by the portfolio preferences of holders of yen and dollar assets at all terms to maturity. These preferences continually change in response to "news" about how the future exchange rate is likely to evolve. And the yen/dollar rate will evolve according to how expansionary the Bank of Japan becomes relative to the Federal Reserve System. Thus, how international investors judge *prospective* monetary policies in Japan vis-à-vis the United States determines today's yen-dollar rate.

The converse of this asset-market approach to the exchange rate underlies hypothesis II. If either or both governments succeed in changing today's equilibrium exchange rate they are credibly telegraphing to the market that relative monetary policies in the future will be different from what international investors had previously presumed. To preserve this credibility, the governments involved must lean—at least implicity—on national monetary authorities to begin altering their monetary policies toward each other in order to sustain today's exchange rate. In this sense, today's exchange rate target "forces" the evolution of relative monetary policies in the longer term. For example, the continual American pressure to appreciate the yen—even if only by "talking it up"—has forced Japanese monetary policy to be relatively contractionary compared to American. Since the early 1970s, the result has been the slowdown in Japanese monetary expansion and the relative deflation shown in Tables 6.2 and 6.6.

Not all the monetary adjustment need be on the Japanese side. Under hypothesis II, the exchange rate can only force *relative* monetary adjustment on the two countries. In the 1970s, American monetary policy was too expansionary and inflationary, in part because the American government was determined to keep the dollar too low in the foreign exchange market against hard-currency trading partners (McKinnon 1982 and 1984). At that time, the relatively deflationary monetary policy forced on Japan by the high yen strategy turned out to be a lucky accident for Japan—unlike hypothesis I would have it. Once the American price level became more stable over the last decade or so, however, recurrent bouts of yen appreciation and deflation have been more damaging to Japan—and to the cause of smoother international adjustment in prices and wages.

A liquidity trap for Japanese interest rates?

Japan's industrial slump in 1993 nicely illustrates how an inappropriate exchange rate can trap the central bank into following an overly deflationary monetary policy. In response to a rising American trade deficit in 1992 into 1993, which was the counterpart of a rising Japanese trade surplus (see

Table 6.5), officials in the new Clinton government intimated in early 1993 that the yen should increase against the dollar. In the first half of 1993, the yen rose from 125 to the dollar in early January to just 105 to the dollar by late July. For mid-1993, Table 6.7 shows that exchange rate which would have more or less equalized producer prices in Japan and the United States: by alternative measures, this purchasing power parity was about 140 to 150 yen per dollar. Because of the yen's further appreciation above its PPP in 1993, the decline in Japan's WPI accelerated from about 1 per cent in 1991–2 to about 4 per cent in 1993 (see Table 6.2). Without drivng the yen back down, the Bank of Japan could not stop the fall in domestic prices.

Although normally exhibiting high positive growth, Japanese aggregate investment slumped in 1992–3 and showed negative growth, as shown in Figure 6.3. Public-sector investment increased sharply in 1992–3, in part because of American pressure on Japan to be more "Keynesian." But this was dwarfed by the huge decline in private investment (see Figure 3), which is highly sensitive to interest rate and exchange rate effects.

As long as the yen remained overvalued, interest rate policy itself was not, and could not have been, sufficient to alleviate the deflation and economic slump in Japan. In September 1993, the BOJ reduced its discount

Table 6.7 PPP estimates for 1993: Q2[1] (For a broad basket of tradable goods unless otherwise noted)

	Yen/dollar	*Mark/dollar*
Long-run averaging method (12-year moving average)	146	2.01
Price pressure method[2]	151	2.00
Economic Planning Agency price survey for consumer durable only[3]	141	2.04
RIIPM price survey on manufactured goods[4]	143	1.85
OECD price survey for machinery and equipment only[5]	134	1.98
OECD price survey adjusted for tradability[6]	181	2.26
Economist Big Mac index[7]	174	2.05

Source: Kenichi Ohno. Tsukuba University, Japan.
Note: actual exchange rates in 1993: Q2 were 110 yen/dollar and 1.62 mark/dollar.
[1] Original estimates for periods other than 1993: Q2 are updated using the Cassel-Keynes method with wholesale price indices.
[2] Kenichi Ohno, *International Monetary System and Economic Stability,* Toyko Keizai, 1991 (Japanese).
[3] Economic Planning Agency, *Bukka [Price] Report* ' 92, October 1992.
[4] Research Institute for International Price Mechanism, Tokyo. The survey results to be published shortly.
[5] OECD, *Purchasing Power Parities and Real Expenditures: EKS Results 1990,* Paris 1992.
[6] Subject to upward biases as the original data include net indirect taxes.
[7] *Economics,* April 17, 1993. The magazine surveys the price of McDonald's popular hamburger annually. Since the product contains both local labor and ingredients and imported materials, the results could be seen as a very limited and mixed PPP index.

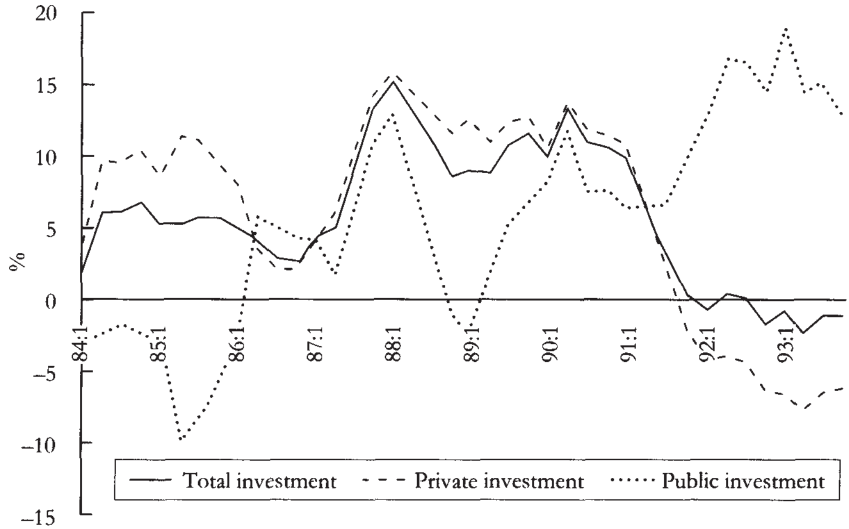

Figure 6.3 Japan: investment growth rate (quarterly data)

rate to an all-time low of 1.75 per cent and interbank lending rates were a little over 2 per cent. Even if nominal interest rates had approached zero, “real” interest rates[8] would still remain high if domestic producer prices were expected to fall—perhaps by more than the 4 per cent fall observed expost facto. Certainly, domestic firms, which were potential investors in fixed assets or inventories, saw increased risk from price-level uncertainty. In addition, the overvalued yen itself made investing in Japan look prohibitively expensive. Instead, many multinational corporations had the option of investing in neighboring countries whose price levels, at prevailing exchange rates, were lower. In effect, Japan was in a Keynesian liquidity trap: the nominal interest rate could not be reduced below zero to get the real interest rate low enough to restore investment and employment to “normal” levels. And because of high national saving but depressed investment, Japan’s trade surplus in 1993 rose to an all-time high of over $140 billion (see Table 6.5).

Nor in 1993 was it possible, even if desirable, to reinflate the “bubble” economy, which had been the way out of the 1986–7 deflation. Badly burned speculators were too close in time to bid up Japanese long-term asset values all over again. Instead, monetary expansion that drove the yen down toward purchasing power parity—by selling yen for dollars in the foreign exchange market if need be—was the most efficient way out. But that avenue was blocked by America's protectionist threats if the Japanese monetary authorities deliberately engineered a fall in the yen!

THE TRADE BALANCE, CURRENT ACCOUNT AND EXCHANGE RATE

Suppose, therefore, we tentatively accept hypothesis II. Rather than passively adjusting, the forward-looking yen/dollar exchange rate has forced changes in relative monetary policies. If so, why, since 1970, has the American government pursued, and Japan acquiesced to, the apparently quixotic policy of continual yen appreciation that imposes relative deflation on Japan with no predictable effect on Japan's surplus or America's deficit on current account?

Rather than with politicians and government officials, the problem lies more with academic economists theory. Policy-makers' views, perhaps formed earlier when they were students, are influenced by theories propounded by academics. The basic theoretical issue is whether or not the exchange rate should be used as an instrumental variable for "correcting" trade or current-account imbalances.

The elasticities model of the balance of trade and the syndrome of the ever-higher yen

The prevailing textbook view derives from the elasticities model of the balance of trade (Robinson 1937; Meade 1951). Suppose a country has a trade deficit[9] and the exchange rate is a variable that the government directly controls by pegging it in the foreign exchange market while sterilizing the domestic monetary consequences. Then, under not very exacting conditions within the context of the model—i.e., if the sum of price elasticities of exports and imports is greater than unity—devaluing that country's currency will reduce the trade deficit in monetary terms. Without going through the painful process of reducing domestic money wages, devaluation is seen as a relatively painless way of reducing uniformly all domestic prices and wages relative to their foreign counterparts.[10] Export expansion and import contraction then follow naturally.

If policy-makers embrace the venerable elasticities model uncritically they see the exchange rate as an instrumental variable for eliminating trade deficits or surpluses. Under the model's thrall, American economic advisers have pressured successive presidents—starting with President Nixon in 1971—to devalue the dollar whenever trade or current account deficits appeared. In addition, because Japan and other industrial countries continued to gain market share in manufacturing, dollar devaluation—by making American manufacturing industries more competitive in the short run—seemed to forestall protectionist pressure. Similarly, academic economists in Japan have viewed yen appreciation as a natural, or "textbook", response for reducing the burgeoning Japanese trade and current-account surpluses. The upshot has been to aggravate the syndrome of the everhigher yen.

But the elasticities model applies only in fairly special circumstances (McKinnon 1981; McKinnon and Ohno 1988). Suppose exchange controls limit capital movements and trade itself is a fringe activity, then the economy is defined to be "insular." The government of an insular economy can peg its exchange rate directly without having to adjust simultaneously its national monetary policy. Because of the exchange controls, the central bank can effectively sterilize the domestic monetary consequences of intervening in the foreign exchanges. With the domestic macroeconomy thus insulated, a devaluation will improve the trade balance if the standard conditions on the price elasticities governing imports and exports are satisfied.

At Bretton Woods in 1944 and for some years afterward when controls on trade and capital flows were almost universal, economies were insular, and the elasticities doctrine was empirically valid for economies that had some slack in resource use. Therefore, in order to limit trade imbalances among what were then insular economies, the Bretton Woods' negotiators wanted pegged but adjustable exchange rates. Because capital flows were restricted, the negotiators imagined that national governments should be fairly free to change the pegs so as to correct trade imbalances.

Today, by contrast, economies are open rather than insular. Capital and trade flows among the industrial economies are huge and virtually unrestricted. Rather than being directly controllable by Treasury authorities, any exchange rate is endogenously determined by the current and prospective monetary policies of the countries in question. Among open economies, the exchange rate behaves as a forward-looking asset price, as per hypothesis II (see pp. 145–6). Because the government cannot directly peg the exchange rate independently of its (future) choice of monetary policy, the endogenously determined exchange rate cannot be predictably related to the net trade balance—or the current account.

For example, consider the financially open Japanese and American economies in 1993. Having policy-makers successfully "talk the yen up" against the dollar early in the year was equivalent to promising market participants either that Japanese monetary policy was going to be tighter, or that that of America was going to be easier, or some combination of the two. In anticipation, aggregate expenditures for (absorption of) all goods and services tended to fall in Japan and to increase in the United States. In the short and intermediate runs, these expenditure effects increased Japan's current surplus, thus offsetting the relative price effect of Japanese goods becoming more expensive compared with American goods.

To summarize, a higher yen, relative to its current purchasing power parity, promises the market that Japanese monetary policy will be relatively tight compared with that of American—as per hypothesis II. In the short and intermediate runs, actual and prospectively tighter money policy reduces aggregate expenditures and is unlikely to reduce a Japanese trade surplus. In the very long run, the real exchange rate and expenditures are unaffected: relative deflation in prices and wages in Japan (see Table 1 and Figure 1) offsets yen appreciation so as to restore purchasing power parity. Between financially open economies, there is no time horizon over which an exchange rate change influences in a predictable fashion the currentaccount balance between them.

THE SAVING SHORTAGE IN THE UNITED STATES, AND JAPAN AS INTERNATIONAL CREDITOR

Rather than an exchange rate issue like the elasticities approach would have it, there is a familiar alternative explanation for burgeoning US trade and current-account deficits: a shortage of domestic saving for financing "normal" levels of investment. Courtesy of the National Research Council (1994), Table 6.8 shows US saving and investment data—both net and gross—from the 1960s through to 1993. From 1960 through 1989, gross investment averaged about 16 to 17 per cent of GNP and then dipped erratically in the early 1990s to about 13.5 per cent of GNP (more on this below). Although its components varied, US private gross saving has remained fairly steady at about 16 per cent of GNP for over three decades—which was, and is, low by international standards. Since 1981, however, government dissaving has risen sharply. In the 1980s and 1990s, the driving force behind the overall American saving shortage has been higher US fiscal deficits, which have varied between 2.5 and 4.7 per cent of GNP (see Table 6.8).

In the past decade, much of this potential savings "gap" has been covered by foreign borrowing from a variety of Asian and European sources. From 1985 through 1989, Tables 6.5 and 6.8 indicate that the US current-account deficit was of the same order of magnitude as the US fiscal deficit—about 2.5 per cent of American GNP—thus financing American investment at "normal" levels so that the Reagan boom could continue.[11] But this left (and still leaves) the American economy vulnerable to any exogenous disturbance in foreign capital inflows that forces a reduction in the current account deficit—i.e., in the economy's access to foreign saving.

The US credit crunch of 1991

When the US current-account deficit narrowed substantially in 1990–2 but the fiscal deficit stayed high (see Table 6.5), a domestic "credit crunch" ensued, with a slump in US investment, which bottomed out at 12.7 per

Table 6.8 US savings and investment (per cent of GDP)

	Net pers. sav.	*Plus: corp. sav.*	*Plus: govt. sav.*	*Equals net natl sav.*	*Plus: forgn sav.*	*Plus: statist. descrip.*	*Equals: net domes. invest.*	*Plus: deprec.*	*Equals: gross domes. invest.*[1]	*Of which plant & equip. was:*
1960–4	4.4	3.4	(0.1)	7.8	(0.8)	(0.3)	6.6	8.6	15.2	9.3
1965–9	4.9	3.6	(0.2)	8.3	(0.4)	0.0	7.9	8.2	16.1	10.5
1970–4	5.9	2.3	(0.5)	7.7	(0.3)	0.1	7.5	9.0	16.5	10.7
1975–9	5.0	2.8	(1.1)	6.8	(0.1)	0.5	7.1	10.4	17.6	11.6
1980–4	5.8	1.4	(2.6)	4.6	0.7	0.1	5.3	11.9	17.2	12.6
1985–9	3.6	1.9	(2.4)	3.0	2.7	(0.3)	5.5	11.1	16.5	11.3
1990	3.2	1.4	(2.5)	2.1	1.4	0.1	3.6	10.9	14.5	10.5
1991	3.5	1.3	(3.4)	1.4	(0.2)	0.4	1.7	11.0	12.7	9.5
1992	3.6	1.8	(4.7)	0.7	0.8	0.6	2.1	11.0	13.1	9.2
1993	3.0	1.9	(3.5)	1.4	1.5	0.2	3.1	10.9	14.0	9.8

[1]Gross domestic investment includes investment in residential structures, changes in inventories, and plant and equipment investment. *Source:* Bureau of Economic Analysis, US Department of Commerce. Data for 1992 and 1993 are from the March 1994 *Survey of Current Business*. Compiled by National Research Council (1994).

cent of GNP in 1991 (see Table 6.8). The resulting fall in real US GDP in 1991 (see Table 2) was sufficient to dis-elect a surprised George Bush! But what was cause and what was effect? Did investment and output fall first, which then reduced imports, the current-account deficit and capital inflows, or the reverse?

Associating the credit crunch of 1990–2 with a sharp slowdown in net capital inflows into the United States is not conventional wisdom. The usual explanation is that over-zealous regulators placed excessive restraint on lending by commercial banks. Because of the newly signed Basle Accord raising bank capital requirements, and because the regulators themselves had been burned by the failure of so many commercial banks and savings institutions in the 1980s, it was alleged that bank regulation became overly restrictive in the early 1990s. And this explanation was sufficiently potent politically to cause the Bush Administration to lean heavily on bank regulators to ease up.

But, on the one hand, this domestic regulatory explanation seems out of keeping with the sharpness and magnitude of the 1991 downturn and, on the other, conflicts with the strange behavior of the term structure of interest rates. Suppose that the domestic regulatory "disturbance" had indeed predominated. Then the sudden preference of American banks for longer—term securities—requiring less bank capital (zero in the case of government bonds) under the Basle Accord—over normal shorter-term commercial lending with high capital requirements, should have driven long-term interest rates *down* relative to short rates. But, as analyzed below, just the opposite happened: US long rates rose sharply.

Without the space or inclination to construct an econometric model to differentiate one hypothesis from another, I identify the initial "cause" to be sudden external restraint in 1990–1 on the US economy's access to foreign capital. In making this identification, we see two factors exogenous to the American economy suddenly reducing capital inflows.

First, the fiscal costs of reunification changed Germany almost overnight from being a big net international lender in 1989 to a net borrower in 1991. Figure 6.4a shows the remarkably sharp fall in Germany's current-account surplus from about \$50 billion per year before 1991 to a deficit of about \$20–5 billion subsequently in 1992–3. The shock took the international financial mechanism—including American borrowers—by surprise and contributed to America's short-term credit *crunch* in 1991.

But what is the longer-term prognosis once the reunification shock wears off? Because the German government's continuing huge fiscal expenditures in the eastern part of the country could last a decade or more, and because the German economy was "unnaturally" depressed in 1992–3 by the Bundesbank's tight-money high-mark policy, Germany seems unlikely to return to current-account surplus and again become a substantial savings sink for the United States. Indeed, an economic recovery in Germany

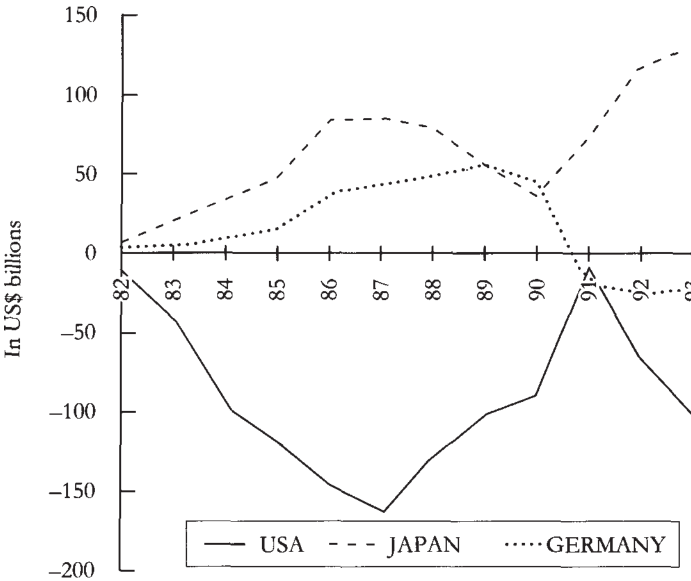

Figure 6.4a Current account, 1982–93 (yearly data)

may well increase imports, with a further deterioration in its current account.

Second, the bursting of the Japanese bubble economy in 1990–1 suddenly reduced long-term capital outflows[12] from Japan, including those to the United States. The crash in the Japanese stock and property markets in 1990 and 1991 so impaired the capital positions of important Japanese financial institutions—banks, insurance companies, trust funds, and so on—that they shifted out of long-term international lending. Consequently, foreign financial capability for buying Japanese goods was reduced so as to narrow Japan's current-account surplus in these two years—as also shown in Figure 6.4a.

This remarkable shift in the pattern of Japanese long-term lending is shown in Table 6.9. Before 1990, long-term capital outflows (column 2) actually overfinanced the Japanese current-account surplus (column 1). The Japanese financial system covered this gap by borrowing short in international markets (column 5), largely by having Japanese banks accept Eurodollar deposits (Tavlas and Ozeki 1992). In effect, Japan behaved as a giant financial intermediary, borrowing short in order to augment its long-term lending—much like the earlier behavior of the United States itself in the 1950s and 1960s.[13] With the bursting of the asset bubble, however, longterm capital was actually repatriated back to Japan in 1991! Table 6.9 shows this swing in long-term capital—from an outflow in the mid-1980s to an inflow in 1991—was a change of about $160 billion annually. And to

Table 6.9 Japan: summary balance of payments, 1980–93 (in billions of US dollars)

Year	*Current account balance*	*Long-term capital account (net)*	*Basic balance*	*Overall balance*	*Short-term capital flows plus errors and omissions*
1980	−10.746	2.324	−8.422	5.03	13.452
1981	4.77	−9.672	−4.902	3.64	8.542
1982	6.85	−14.969	−8.119	−4.7	3.419
1983	20.799	−17.7	3.099	1.55	−1.549
1984	35.003	−49.651	−14.648	2.12	16.768
1985	49.169	−64.542	−15.373	−0.58	14.793
1986	85.845	−131.461	−45.613	14.84	60.453
1987	87.015	−136.532	−49.517	37.94	87.457
1988	79.631	−130.92999	−51.299	16.52	67.819
1989	57.157	−89.246	−32.089	−12.76	19.329
1990	35.761	−43.586	−7.825	−6.59	1.235
1991	72.901	37.057	109.958	−6.63	−116.588
1992	117.551	28.459	89.092	0.63	−88.462
1993	131.35	−78.091	53.259	35.95[p]	−17.309[p2]

[1] Changes in Official Reserves.
[2] p=preliminary
Sources: International Monetary Fund, International Financial Statistics Bank of Japan. Balance of Payments Monthly.

complete our picture of this radical change in the external balance sheet of the Japanese financial system, about $117 billion of short-term capital flowed out of Japan in 1991 (column 5)—largely by the Japanese banks running off much of their Eurodollar liabilites—as the counterpart of the inflow of long-term capital coupled with a current-account surplus.

The direct effects of these two shocks on the German and Japanese economies and the world at large were complex. By 1991–2, the collapse in domestic asset values had significantly depressed the Japanese economy, with declines in industrial output and sluggish growth in real GNP (see Table 6.1). However, my main concern here is the echo effect of these two more or less simultaneous shocks on the American economy over 1990–2, with their impact most sharply focussed in 1991. Not only was the total amount of foreign capital available to the American economy suddenly reduced but, because of the Japanese financial crash, the form of finance shifted dramatically from long term to short term.

Nevertheless, the undiminished US fiscal deficit—resulting in bond issues of about $270 billion per year in 1991 (see Table 6.5)—had somehow to be financed. In 1991, the US yield curve began to steepen sharply. Long-term interest rates rose from being 1 or 2 percentage points higher than short rates at the beginning of the year to being over 4 percentage points higher at the end. In the absence of foreign buying of US Treasury bonds and other long-term securities, the bond-market yield curve had to steepen sufficiently to make bonds attractive to domestic financial institutions and individuals. By mid-1991, normal lending by commercial banks began to fall sharply. Instead of meeting the normal working capital needs of American business, commercial banks bought treasury bonds and other securities in order to play the yield curve to increase their profitability. In addition, there was disintermediation: people who normally held shortterm bank deposits (M2) switched to longer-term, higher-yield bonds. The resulting sharp fall in normal bank lending in 1991 created what was then called "the credit crunch."[14] It induced the American cyclical downturn in 1991 and sluggish growth in 1992.

A fuller statistical analysis of this episode is beyond the scope of this paper. Here, I just illustrate how dependent the American economy has become on foreign capital. Future disruptions in its availability could work themselves out financially somewhat differently.

Japan as dominant international creditor in the 1990s?

In 1993, Japan's deepened slump in domestic investment from the overvalued yen released a huge amount of saving on to the world market: her current account surplus ballooned to over $130 billion. Recovering from the financial calamities of 1990–1, Japanese investors once more began to invest at long term overseas: outflows rose to $78 billion in 1993 (see Table 6.9). But this long-term financial outflow remained substantially less than the huge current-account surplus. Unlike the 1980s, long-term capital outflows are (1993–4) not yet fully financing, let alone "over" financing, Japan's savings transfer to the rest of the world.

Nevertheless, complaints of a credit crunch disappeared from the American financial press. Although still below normal, US gross investment did recover to about 14 per cent of GNP in 1993 (see Table 6.8). As in the 1980s, this was made possible by the sharp increase in foreign capital inflows. Table 6.5 shows the US current account deficit reached about $109 billion in 1993, and US long-term interest rates fell by about 2 percentage points compared to 1991, although they still remained about 2.5 percentage points above short rates. With this relaxation of the capital constraint, we have the "Clinton boom" in 1993 into 1994.

In contrast to the 1980s, however, Japan emerges as the overwhelmingly dominant creditor country in the world economy of the 1990s. Her currentaccount surpluses now exceed America's deficits (see Table 6.5). Other savings sinks on which the United States had relied in the 1980s, Western Europe in general and Germany in particular, have disappeared and are now net borrowers in the world economy—as shown in Figure 6.4b. By 1993, other prospering Asian economies—China, Singapore, Taiwan and South Korea—had reduced their collective saving (current-account)

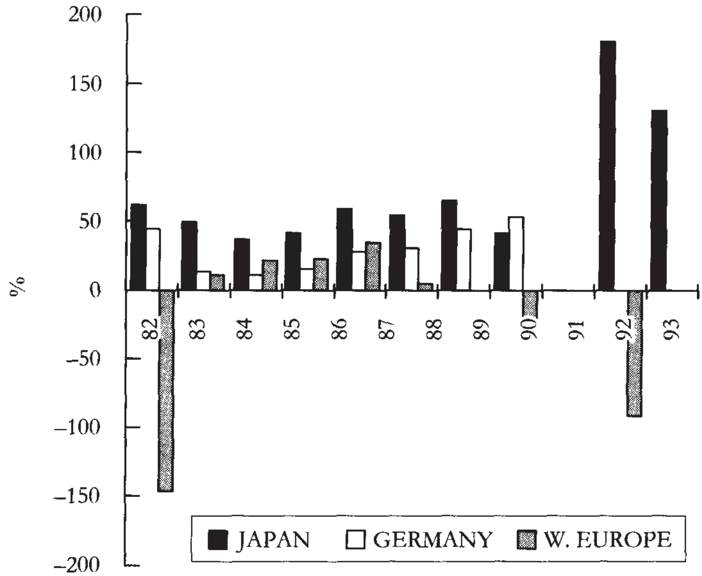

Figure 6.4b Foreign saving sources for the US, 1982–93* (yearly data) * percentage of US current-account deficits

surpluses to negligible levels. In the remainder of the 1990s, how secure is this sole source of net finance for the world economy?

In the short run, any "normal" recovery of Japanese domestic investment (see Figure 6.3) will substantially reduce the size of Japan's saving surplus from that seen in 1993–4. Even so, if we project the domestic investment that prevailed in Japan in the 1980s into the later 1990s, its high private saving should still generate substantial, if smaller, current-account surpluses.

In the longer run, any projections are very speculative. On the pessimistic side, if Japan embarks on Keynesian-style fiscal "expansion" to alleviate its economic slump while, incidentally, eliminating its current-account surplus, the result would be a worldwide credit crunch. Figure 6.3 shows the already-high percentage increase in Japanese public-sector investments in 1992–3. Higher government expenditure and lower taxes in Japan would reduce the vital source of saving on which the rest of the world—most particularly the United States—depends so heavily.

More optimistically, suppose that Japan recovers from its high-yen slump by a properly managed monetary expansion with some real exchange depreciation but no significant impairment of the economy's high-saving capacity. Then the ongoing financial problem between Japan and the United States is one of managing the savings transfer between the two economies more efficently without provoking similar macroeconomic disruptions in the future. In effect, any new exchange rate regime should seek to restore stability in "real" exchange rates—i.e., as measured by broad baskets of tradable goods—much as it existed in the 1950s and 1960s.

To further limit interest volatility—including asset "bubbles" and credit "crunches" in the future—the incredible ebb and flow of long-term capital from Japan should also be smoothed. But, between financially open economies, this smoothing is largely a question of harmonizing national monetary policies to assure the capital markets that *nominal* exchange rates will remain stable in the *long run*. Otherwise, as they try to guess the future evolution of the yen/dollar and other exchange rates, international investors will continue to churn their portfolios of yen versus dollar, or shortversus long-term, financial instruments.

PURCHASING POWER PARITY AND MONETARY COOPERATION

For monetary cooperation to be successful between any pair of economies like Japan and the United States, or within a broader group of industrial economies, the focal point must be a common price-level objective—before moving on to exchange rate stabilization per se. Such a pact would be satisfactory only if the common price level was truly anchored, and each national monetary authority could report to its government that it was stabilizing "the" domestic price level as well as the exchange rate.

The choice of a suitable price index is then critically important in ensuring that, if each participating government actually hits its price-level target, the result would be fully consistent with maintaining fixed nominal exchange rates (within narrow bands) into the indefinite future because the purchasing powers of national monies are more or less equalized. Elsewhere, I have argued (McKinnon 1988, 1993 and 1994) that broad price indices for tradable goods which are already in common use—the Wholesale Price Index (WPI) or the closely related Producer Price Index (PPI)—have this desirable characteristic. And this conclusion is fully born out by the earlier Japan-US experience, when the yen/dollar rate was fixed for over twenty years.

Many, but not all, of the desirable features of ongoing cooperation between the BOJ and the FED were realized during the 1950s and 1960s. A relatively expansionary monetary policy by the BOJ was consistent with pegging the exchange rate at 360 yen/dollar on the one hand, and stability in the common price level for tradable goods (the American and Japanese WPIs) on the other (see Figures 6.1 and 6.2). At this stable price level, workers could bargain so that, on average, money wage growth more or less matched the growth in manufacturing productivity in each country. In effect, the two monetary authorities behaved as if "price" stability meant stability in tradable goods prices rather than in their domestic CPIs, where Japanese

CPI growth was naturally much higher than American because of higher equilibrium growth in money wages. To be consistent with exchange rate stability, any future monetary pact should also target the common price level measured in tradable goods, while tolerating (slightly) different growth rates in member countries' CPIs if necessary.

Although this price-level objective would remain the same in any future monetary pact, the operating procedures followed by the BOJ and the FED for getting there would necessarily be somewhat different. The marked asymmetry characterizing the fixed-rate dollar standard of the 1950s and 1960s—where the FED independently targeted the common price level and the BOJ pegged the exchange rate—would be both politically unacceptable and economically inefficient in any new, more symmetrical regime.

The political unacceptability of reintroducing the fixed-rate dollar standard of the 1950s and 1960s, where the USA could successfully focus on stabilizing its own price level and pretty well ignored the economic circumstances in other countries as long as they maintained their dollar exchange parities, is obvious. This international monetary asymmetry arose naturally out of the aftermath of the Second World War—particularly the success of postwar reconstruction under the Marshall Plan in Europe and the Dodge Plan in Japan (McKinnon 1993). But any new pact between Japan and the United States should be a more symmetrical partnership. The weight of the huge Japanese economy in both the financial and commodity markets is now such that the US can no longer easily provide the nominal anchor for both countries. The state of Japan's macroeconomy now makes a difference to the cyclical stability of the American economy itself.

Elsewhere, I have gone into more details on how such ongoing cooperation might be structured (McKinnon 1988 and 1994). Here, it suffices to note that both central banks should gear their domestic credit expansion to stabilizing their internal WPIs (tradable goods prices). This would be consistent with a nominal exchange rate target, based on the principle of purchasing power parity (PPP), that aligned these two (stationery) WPIs, as per the 1950s and 1960s. If the market value of the yen/dollar rate tended to stray from this initial PPP rate, fairly minor symmetrical monetary adjustments—for example, through lowering short-term interest rates in one country and raising them in the other—would be likely to be sufficient to bring it back. Failing that, concerted official intervention in the foreign exchanges[15] would be relied on to keep the rate with a pre-announced narrow band.

In the early years of this cooperative agreement, the exchange rate band might be kept fairly broad—say 6 or 8 per cent wide. If and when the pact was seen to be successful for some years, the band could be progressively narrowed toward 2 per cent. But Japan and the United States would have a nominal anchor in common: their commitment to stabilize their domestic WPIs.[16] To minimize stress, each monetary authority could give some weight to the other country's WPI in its own decision-making. Such symmetry is all important to avoid a European-style debacle, where Germany—read the Bundesbank—in 1992–3 determined its monetary policy unilaterally, irrespective of the needs of the rest of the community.

The transition problem

It is far easier to sketch the nature of Japanese—American monetary cooperation in a steady state, drawing on the experience of the 1950s and 1960s, than to sketch possible transitions to this desired equilibrium. In the third quarter of 1994, the yen remains extremely overvalued by any measure of purchasing power parity based on the alignment of national WPIs. Using several direct and indirect measurement techniques shown in Table 6.7, Kenichi Ohno estimated that in the second quarter of 1993 the PPP yen/dollar rate would have been between 140 and 150. By comparison, the highly volatile market rate averaged about 110. In the third quarter of 1994, with the market rate at about 100, the drift in the PPP rate (see Figure 5) probably places it in the neighborhood of 135.

The overvaluation of the yen is only one aspect of the current disequilibrium. Unfortunately, the last twenty years of forced deflation in Japan vis-à-vis the United States has set in motion a declining price level (measured by the Japanese WPI) and, less tractably, unduly low growth in Japanese money wages in

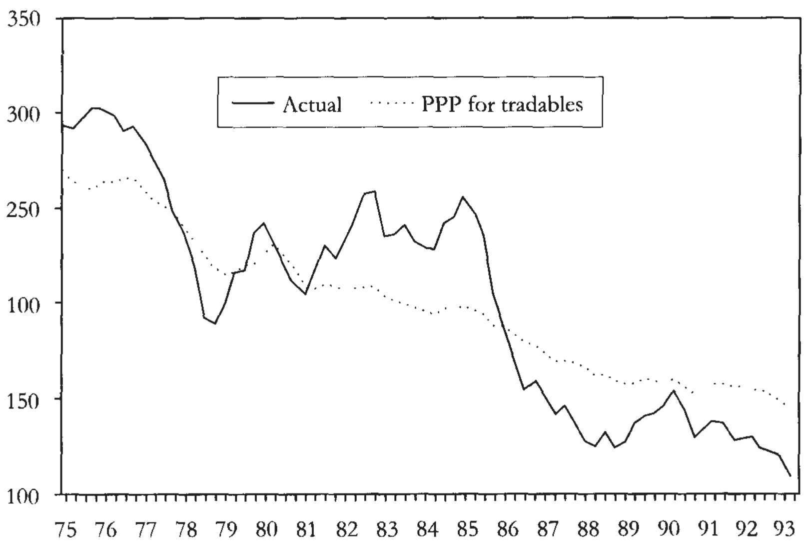

Figure 6.5 Actual and PPP yen/dollar rates

Source: IMF, International Financial Statistics, CD-ROM, June 1993. The purchasing power parity rate is estimated by the 12-year long-run averaging method using wholesale prices

1993 into 1994. Because the lags behind the exchange rate in this wage price deflation are substantial (Ohno 1990), one would expect the PPP yen/dollar rate to continue to drift downwards (as shown in Figure 6.5) even if there was a major monetary correction. If the BOJ expanded Japanese monetary policy to drive the yen/dollar rate upwards and pull Japan out of its current deflationary slump, increased growth in money wages would come only with a lag.

How does one achieve monetary expansion in Japan's current (1994) circumstances? The scope for further interest rate cuts in Japanese money markets is limited because nominal interest rates are bounded from below by zero: the Keynesian liquidity trap discussed above. An effective easing of Japanese monetary policy might well require the BOJ to buy dollars directly with yen—that is, to use unsterilized intervention in the foreign exchanges to bring the yen down and stop Japanese producer prices from falling.

Laying out the most efficient transition, taking into account all the lags involved, to the blissful steady-state equilibrium sketched above, is complicated and would require a separate paper. However, we can safely say that short-run monetary expansion in Japan should aim to drive the current yen/dollar rate up sharply—but not all the way to 135 yen. Because of PPP drift, that would cause some overshooting in the yen/dollar rate, in the sense that it might have to come down again at some future time if PPP is to be maintained. Rather, with American cooperation, current monetary expansion in Japan should aim for some intermediate rate—say, 120 to 125 yen/dollar. If the calculations were done right such an exchange rate could be sustainable into the indefinite future, and the PPP rate, with everslowing drift, would eventually converge to this "market" rate. Japan's (and America's) WPI would stabilize, Japanese money wages would start growing faster, and the machinery sketched above for our blissful, if hypothetical, steady state could kick in. But the official exchange rate band could not be narrowed and hardened until national interest rates became fairly well aligned (McKinnon 1994).

The faint of heart do not have to buy my ideas for long-term monetary cooperation between Japan and the United States to agree with the conclusion that, in the short run, there should be a strong monetary expansion in Japan, which can only happen if the yen depreciates. Besides buoying the American economy, the consequent revival of the Japanese economy will reduce (but not eliminate) the trade and current-account imbalances between them. There is no conflict between the short-and long-run direction of desirable change in current Japanese monetary policy.

But fiscal policy is a different story. If the Japanese undertake a fiscal "expansion," as some Americans have (perversely) urged them to do, this will destroy a saving resource on which the American economy is highly dependent. To minimize the frictions involved, the American government should agree that Japanese monetary expansion, accompanied by the inevitable yen depreciation against the dollar, is also in the best interests of the United States.

NOTES

1 I would like to thank Kenichi Ohno of Tsukuba University for his invaluable help in preparing this paper. Thanks also to Ralph Landau, Hiroshi Nakamura and Timothy Taylor of Stanford University.
2 Under the old fixed-rate dollar standard of the 1950s and 1960s, most industrial countries other than the United States maintained exchange controls on capital account.
3 Under the Bretton Woods Agreement of 1945, the American commitment to convert official foreign holdings of dollar assets—largely Treasury bills and bonds—into gold at $35 per ounce, may have restrained the US government from running fiscal deficits. This agreement was formally terminated in August 1971, when President Nixon slammed the gold window shut.
4 Measured productivity growth typically tends to be higher in goods production than in services: the well-known "Balassa effect" (Balassa 1964). Because wages in both goods and services moved together and tracked the higher productivity growth in Japanese manufacturing, the price of services in Japan rose fairly fast. And services are a significant component of the CPI but do not enter the WPI. Thus the Japanese CPI rose between 3 and 4 percentage points per year faster than its WPI (see Table 6.2).
5 Line 34 of the IMF's *International Financial Statistics,* which corresponds roughly to "M1"—coin and currency plus checking accounts in commercial banks.
6 Although not identical, movements in domestic producer price indices track those in the WPI very closely. For purposes of this analysis, producer prices might be slightly preferred. But only WPIs are available in a very long historical time series going back to the early 1950s—as per Table 6.2 and Figure 6.1.
7 Because of last-ditch efforts by countries like Japan to defend their dollar parities and prevent their currencies from appreciating, their domestic money supplies exploded in the early 1970s (McKinnon 1982).
8 In deflating nominal interest rates in order to construct real ones, which price index one selects makes a big difference. In 1993, the Japanese consumer price index actually rose slightly—1.2 per cent as shown in Table 6.2. In McKinnon (1979: Ch.10), I make the argument that the producer price index is the more appropriate deflator for measuring the real interest rate entering business decision-making on new investment.
9 Within the confines of the elasticities model, the trade deficit is usually not distinguished from the deficit on current account.
10 Ohno (1993) provides convincing evidence to the contrary. Rather than smooth and uniform adjustment, sharp exchange rate changes heavily distort relative prices in the economies in question.
11 Earlier in 1982–3, the ballooning US fiscal deficit was not offset by similarsized current-account deficits (see Table 6.5) and investment did fall below normal. The Volcker disinflationary shock then was the prime determinant of the output slump in the American economy and the partly endogenous rise in the fiscal deficit.
12 Direct and portfolio investments, including bank lending, in instruments greater than one-year duration.
13 One significant difference, however, is that in the 1980s most of Japan's external

assets and liabilities were not denominated in its own currency—but in US dollars (Tavalas and Ozecki 1992)—whereas, in the 1950s and 1960s, the US dollar was the numéraire currency for America's external assets and liabilities.

14 If one accepts the hypothesis that domestic banks are special in serving smaller industrial enterprises where customer relationships and specific knowledge are important (Gertler and Gilchrist 1992), then any sudden dimunition of normal lending could not immediately (in 1991) be offset by borrowing from other sources—e.g., issuing commercial bills—at home or abroad. But in the longer run, many enterprises could escape from the banking crunch by turning to other sources of finance.

15 Since the .Plaza and Louvre Accords of 1985–7, the evidence is now pretty strong that sterilized official intervention can work—as long as it is concerted and open (Dominguez and Frankel 1993).

16 Producer price indices—which track WPIs rather closely—might provide a slightly better nominal anchor for the two countries. Price movements originating in third countries are more likely to be excluded. In addition, the authorities must track price levels, rather than inflation rates, for the fixed exchange rate regime to hold together (McKinnon 1994).

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7

MONETARY UNION IN SOUTHERN AFRICA

Chris Stals

THE GLOBAL EXCHANGE RATE SYSTEM

The demise of the Bretton Woods exchange rate system of fixed parities and the introduction of the floating exchange rate regime for the currencies of the major industrial countries left smaller countries with a few difficult choices for the management of their own exchange rates:

- Some smaller countries linked their currencies to the currency of one of the major industrial countries, preferably the one with which they had dominating trade and financial relationships.
- Others linked their exchange rates to some composite international currency, such as the SDR or ECU.
- For some smaller countries, it was more advantageous to establish a composite base of an average weighted value of the currencies of their major trading partner countries, and to link their exchange rates to this basket.
- In some cases, where domestic markets in foreign exchange had reached a sufficient degree of sophistication, smaller countries also introduced independent, managed, floating exchange rates for their currencies.

The floating exchange rate regime did not live up to its expectations. In particular, it made little contribution to more swift and autonomous adjustment of international payments imbalances, as was held out initially. Neither were countries relieved of the burden of maintaining external equilibrium through periodic adjustment of domestic macroeconomic policies. Monetary and fiscal policies were not set entirely free to pursue the national objectives of full employment and stable prices.

On the contrary, volatile exchange rate movements amongst the major currencies of the world in recent years complicated the task of smaller countries to promote economic growth and development. As the system emerged and the major countries developed greater cooperation amongst themselves, for example within regular G7 meetings, the smaller countries were left even more in the lurch. All the efforts at greater overall macroeconomic convergence were of no value for the smaller countries, who were often excluded also from regional cooperation arrangements, such as the Exchange Rate Mechanism of the members of the European Union.

In the absence of transparent global rules for exchange rate management and with a lack of an international commitment to exchange rate stability, competitive exchange rate depreciation is often being encouraged, as an acceptable policy objective for smaller countries. This encouragement sometimes comes even from unexpected quarters, such as the World Bank and also, perhaps slightly more covertly, the International Monetary Fund.

EXCHANGE RATE AND MONETARY COOPERATION IN SOUTHERN AFRICA

Caught in the turmoil of these developments, a number of smaller countries in Southern Africa developed a monetary cooperation system that also provides for a more stable exchange rate regime within the region. Restricted by the constraints of political differences in the region and without any meaningful international support or recognition, the multilateral monetary arrangements in Southern Africa remained modest, with full participation by only a few countries. There is, however, a growing opportunity for a wider application of the existing arrangements.

Although developments in the global system in recent years encouraged monetary cooperation on a regional basis, the multilateral monetary arrangement in Southern Africa has more of a historical background. It reflects in part the remnants of overall political and economic integration between a few countries that were, somewhere in their history, colonial components of the former British Empire. Unlike similar arrangements in other parts of the world, the common monetary area in Southern Africa in the past reflected a centrifugal force, that is a movement by a few smaller countries away from the inner core of the more advanced economy of South Africa. The evolution from the informal monetary integration of the first six decades of this century to the more formal system of the past two decades coincided with the attainment of independent political status of the countries of Botswana, Lesotho, Swaziland and Namibia, and with the temporary departure of South Africa from the British Commonwealth in 1961.

In the light of recent political changes, particularly in the Republic of South Africa, the prospects for a new, more centripetal form of monetary cooperation in Southern Africa are increasing. South Africa itself has just recently joined the Southern Africa Development Community (SADC) and, although this treaty does not provide for any formal monetary cooperation, it does encourage the free movement of capital between its members, and the extension of cross-border economic ties. The South African Reserve Bank has also been invited to join the Association of African Central Banks and will hopefully, in the not too distant future, participate more actively in the Southern Africa Regional Committee of this Association.

The present monetary cooperation in Southern Africa has at its centre the Multilateral Monetary Agreement that creates a common monetary area in the region, with the four countries of South Africa, Lesotho, Namibia and Swaziland as full members. Details of this monetary cooperation agreement appear in the Appendix to this paper. The main characteristics of the monetary union between these four countries are the following:

- There are no restrictions on the free movement of capital and goods between the countries.
- The four countries apply a common exchange control policy towards the outside world.
- Although the South African rand serves as a de facto common currency that is widely used and accepted in all the participating contries, each one of the other countries also issues its own national currency which is, de jure, legal tender only in the region of the issuing country.
- In practice, all the currencies of the region maintain parity against the South African rand, and the four countries therefore have the same exchange rates against outside currencies.
- The countries share in a common pool of foreign reserves, managed by the South African Reserve Bank. The other members nevertheless also have a right to hold foreign reserves which are managed by themselves and which are adequate for their own immediate needs.
- The multilateral cooperation agreement has a built-in flexibility to accommodate the ever-changing needs of the various participants. Over the past twenty years, several bilateral agreements were entered into, mostly between South Africa and one of the other participants, to provide for greater autonomy for the other countries within the spirit of continued monetary cooperation in the region.

Monetary co-operation in Southern Africa extends beyond the formal signatories of the Multilateral Monetary Agreement. Certain other countries in Southern Africa—for example, Botswana, Mozambique, Zimbabwe, Zambia and Malawi—all have some form of economic cooperation with the Republic of South Africa. In most cases, these arrangements cover aspects such as trade and labor movements, without any formal provision for monetary cooperation. The South African rand is, nevertheless, fairly widely accepted in these countries, and certain repatriation arrangements exist between the South African monetary authorities and those of the neighboring countries for the exchange of rand notes.

Some of these outer countries also recognise the importance of the rand exchange rate for their economies and retain some form or other of informal linkage to the South African rand. In the cases of Botswana and Zimbabwe, for example, this recognition takes the form of a dominating weight for the rand in the formula used to determine an average weighted value as a basis for the exchange rates of the Botswana pula and the Zimbabwean dollar, respectively.

PROSPECTS FOR FUTURE MONETARY COOPERATION IN SOUTHERN AFRICA

In the past, few important constraints restricted the further expansion of monetary cooperation in the Southern Africa region:

- First, there was the political constraint of the unacceptable South African socio-political system, which precluded constructive cooperation between the relevant countries at government level. This constraint has now been fully removed.
- Second, the extensive foreign exchange controls still applied by countries in the region, and particularly by South Africa, retarded the expansion of multilateral monetary cooperation in the region. It is the intended policy of South Africa, and of other countries in the region, to liberalize the remaining exchange controls and to provide for a more free regime of international capital movements. The relaxation of the exchange controls should facilitate and stimulate cross-border monetary cooperation amongst the countries of Southern Africa.
- Third, financial instability in the region, reflected in volatile exchange rates, high rates of inflation and large fiscal deficits, complicated monetary cooperation between countries. This may for the time being continue to preclude a comprehensive monetary union for all Southern African countries, unless all the countries can work in a more concerted way towards a common goal of overall financial stability for the whole region.
- Fourth, the great divergences that exist in the stage of development of the financial systems and markets in the various countries in the region also make full monetary integration extremely difficult. Other countries in the region fear domination by the relatively well-developed and sophisticated South African financial institutions and markets.
- Fifth, the limited macroeconomic resources at the disposal of all the countries in this region, including South Africa, make economic cooperation across borders more difficult. Governments are inclined to regard immediate national objectives as being of greater importance than the longer-term advantages that may flow from enhanced international monetary cooperation.

Against this background, and taking account also of the recent developments in the global monetary system, there are interesting challenges for greater monetary cooperation amongst the countries of Southern Africa. This cooperation may eventually even extend to the whole Sub-Saharan Africa region. The experience gained with monetary cooperaion in the Multilateral Monetary Agreement amongst the four countries of Lesotho, Namibia, South Africa and Swaziland can serve as a very useful basis for an extended system of monetary cooperation in Southern Africa. I believe such extended co-operation will be in the interest of economic development in the whole region and that it deserves the support of the international community.

APPENDIX: THE MULTILATERAL MONETARY AGREEMENT BETWEEN THE REPUBLIC OF SOUTH AFRICAL, LESOTHO, NAMIBIA AND SWAZILAND

Introduction

The Multilateral Monetary Agreement (MMA) provides an important basis for regional cooperation in the financial area in Southern Africa. Although the structure of and name for this arrangement changed on various occasions during its existence, the original, basic aims of greater monetary stability in the region and better economic and financial cooperation among member states remained intact.

In this brief study, a short historical review of applicable developments will be followed by a discussion of various aspects relating to the Agreement and its implications for the Southern African region.

The origin of the agreement

From 1910, when the Union of South Africa was formed, and from even before that time, until 1974, Botswana, Lesotho and Swaziland (BLS countries) used the South African currency in their economic activities and were fully integrated in the Rand Monetary Area (RMA) without any formal agreement. These informal arrangements had certain drawbacks, such as the lack of monetary discretion for the BLS countries, a regular flow of savings.generated within the BLS countries to South Africa and a lack of any institutional framework for consultation. On the other hand, there were a number of advantages in the arrangements for the BLS countries—for instance, relative and absolute stability for exchange rates for intra-BLS—SA transactions and the promotion of higher regional output and employment, with capital funds moving freely within the region.

In 1972, after extensive investigations and also acting upon advice from the International Monetary Fund and the Bank of England to remain closely linked to the South African monetary system, these countries, having attained independent national status from the United Kingdom, started negotiations with South Africa on monetary and related matters. In March 1974, a bilateral agreement was signed between Swaziland and South Africa, in the terms of which Swaziland was to establish a monetary authority and issue its own currency (lilangeni) which was to circulate alongside the rand within the country at an exchange rate of 1:1. In September 1974, Botswana announced its intention to establish its own fully independent central bank and issue its own currency which would replace the rand completely. It thereby also established an independent exchange rate for Botswana, the pula. Subsequently, on 5 December 1974, a formal monetary agreement was signed between the Republic, Swaziland and Lesotho, with Botswana opting out. The agreement was known as the Rand Monetary Area (RMA) Agreement, and the rand remained legal tender in the three countries involved.

The RMA Agreement came into force when it was signed in 1974 and has proved to be relatively successful in its aims. It is today accepted as the anchor for financial integration and cooperation in the region. Over time, some changes have been made to the original arrangements, which will be referred to later. Bilateral agreements were entered into between South Africa and individual member states to supplement the multilateral agreement and to introduce a necessary measure of flexibility. These special bilateral arrangements were not always fully compatible with the detailed provisions of the main agreement. Any two contracting parties wishing to enter into a bilateral agreement had to give prior notice on such agreements, or changes thereto, to the remaining parties.

The RMA was replaced by the Common Monetary Area (CMA) on 1 July 1986, which was a new trilateral monetary area agreement between South Africa, Lesotho and Swaziland. The new agreement accommodated the changes implied by the then existing bilateral agreement involving Swaziland and South Africa. This trilateral agreement was, in turn, replaced by a third Multilateral Monetary Agreement (MMA) on 6 February 1992, when the Republic of Namibia became politically independent from South Africa and formally joined the Common Monetary Area. Even before this date, Namibia was regarded and accepted as a de facto member of the previous trilateral arrangements.

Aims of the agreement

In the preamble to the RMA, the advantages of maintaining the Common Monetary Area were acknowledged and the purposes of the agreement were indicated, *inter alia,* as follows:

- The monetary arrangement should provide for sustained economic development of the CMA.

- The informal and long-existing monetary arrangements in the CMA should be formalized in the form of a multinational agreement.
- The arrangements should encourage the advancement of the less-developed members of the CMA.
- All parties should be afforded equitable benefits from the maintenance and development of the CMA as a whole.
- It was recognized that each of the contracting parties should remain responsible for its monetary policy and the control of its financial institutions.

These objectives were carried forward into the subsequent agreements and still apply in the present MMA.

Salient points in the multilateral monetary agreement

Legal tender

In terms of the original agreement of 1974, all countries in the CMA accepted the SA rand as legal tender in their territories. Member states, however, were given the right, subject to certain conditions, to issue their own national currencies in addition to the South African currency. Prior agreement between the government of South Africa and the issuing government was required for the issue of a national currency. Coin and notes issued by any member should be clearly distinguishable in appearance from notes and coin of other contracting parties. All three countries in the agreement have made use of this provision. Swaziland had already begun to issue its own currency, the lilangeni, in 1974 and Lesotho followed suit with its loti in 1980. Namibia became a full member of the CMA in March 1992 and from September 1993 issued its own currency, the Namibian dollar. The currencies of these three countries have all been pegged to the South African rand at par since their introduction. Banknotes issued by these three countries are freely convertible into rand but are not legal tender in South Africa.

In terms of a revised bilateral monetary agreement entered into between the Government of Swaziland and the Government of the Republic of South Africa, the rand currency, with effect from 1 April 1986, ceased to constitute legal tender in Swaziland. The revision was prompted by four major considerations:

1 There was a perception that the depreciation of the lilangeni as a result of the depreciation of the rand, to which it was tied on a 1:1 basis, adversely affected economic circumstances in Swaziland. It should be noted, however, that the exchange rate of the lilangeni against the rand has remained on par ever since.

2 The volatility in South Africa's foreign exchange market due to international

pressures created uncertainties for the other countries, as exchange reserves were common to all parties.

3 The relatively high inflation in South Africa became unacceptable to Swaziland. It was felt that this inflation could perhaps be reduced via an adjustment to the exchange rate in the same way as Botswana had been able to do.

4 The agreement limited the discretion exercisable by Swaziland in areas of money supply and interest rates. Money supply could not be managed independently by the Swazi authorities owing to the 100 per cent randbacking requirements for the issue of lilangeni. Departure from interest rate structures in South Africa could also result in disruptive movements of capital between the two countries.

The changes to the agreement provided greater autonomy for Swaziland in the area of exchange regulations and the conversion of its currency. The rand lost its status as legal tender in Swaziland, and the value of the lilangeni was delinked from the rand. The South African rand, however, remained legal tender in both Lesotho and Namibia as before.

Transfer of funds within the region

No restrictions apply to the transfer of funds, whether for current or for capital transactions, to or from the area of any other contracting party. Limited exceptions are allowed. A party may apply restrictions as part of the prudential investment of liquidity requirements prescribed for financial institutions, provided that such restrictions are not discriminatory against any other contracting party and that proper notification is given. Contracting parties may also introduce measures relating to the investment of funds in domestic securities in the interest of the development of their respective areas.

If a contracting party has reason to believe that funds have been transferred in order to evade measures introduced by any other contracting party it must consult that party to rectify the matter.

Access to the South African capital and money markets

The governments and state-owned or—controlled bodies, local authorities and public utilities of Lesotho, Namibia and Swaziland, together with financial institutions and business enterprises in these countries, will, subject to relevant financial laws and policies applicable to counterparts in South Africa, have a right of access to the South African capital and money markets.

To promote the orderly management of these markets, the government concerned must, in respect of the issue or conversion of securities, reach agreement with the South African authorities on conditions, timing and other relevant terms, and South Africa may not withhold its agreement without reasonable cause.

The contracting parties accept the need for preserving monetary stability in the CMA, and in this regard the governments of Lesotho, Namibia and Swaziland will have the right to enter into bilateral arrangements with South Africa with the aim of obtaining, under special circumstances, temporary central bank credit facilities from the South African Reserve Bank on such terms as may be agreed upon at the time.

Gold and foreign exchange transactions

Each member of the CMA is the sole authority responsible for handling foreign exchange transactions relating to its area, including the appointment of authorized dealers in foreign exchange. The contracting parties must exercise their authority in respect of gold and foreign exchange transactions in accordance with the policies adopted by the CMA for the management of these foreign reserves.

Initially, foreign exchange holdings of the three smaller members of the CMA consisted mainly of rand and rand balances held at the South African Reserve Bank. A more flexible system has since been introduced to allow some autonomy for the diversification of each country's foreign reserves in other convertible currencies.

In terms of the original agreement, all gold and foreign exchange reserves of the RMA were pooled and administered by the South African Reserve Bank. However, from April 1986 Swaziland assumed responsibility for the management of its own foreign assets. The bilateral agreement between Lesotho and South Africa in 1989 also gave Lesotho permission to apply more discretion in the management of its own foreign currency reserves.

The relevant bilateral agreements between South Africa and the other three contracting parties ruled further in this regard as follows:

- The central banks of the three countries will, together with authorised foreign exchange dealers, have access to the foreign exchange market in South Africa.
- In addition, the government of South Africa will, if necessary, request the South African Reserve Bank to make available the required foreign exchange for transactions of participating governments or authorized dealers.

To enable the South African authorities to manage the gold and foreign exchange reserves of South Africa, to monitor exchange control of the CMA and to assist in determining exchange rate policy, the central banks of Swaziland, Lesotho and Namibia must provide the South African Reserve

Bank with monthly information on balances and transactions in gold and foreign exchange undertaken by themselves and by their authorized dealers, together with the applicable exchange control forms.

Exchange controls

The system of exchange control in force in South Africa, as amended from time to time, is in all material aspects substantially in agreement with the exchange controls applied by the governments of Lesotho, Namibia and Swaziland. Should any of these governments consider that its national interests will be adversely affected by amendments implemented by South Africa it will not be obliged to incorporate such changes into its own exchange control provisions, but timely notification to other contracting parties is required.

Each member of the CMA must ensure that the gold and foreign exchange accruing to its residents should, subject to its exchange control provisions, be sold to any appointed authorized dealer in foreign exchange. The contracting parties are obliged to enter into consultations at the request of any member state in respect of any exchange control matter, particularly where exchange control provisions of another contracting party are evaded.

In the event of any amendment to the rules, foreign exchange transactions in process will still be handled and completed in terms of former rules.

Member states of the CMA participate in the dual exchange rate system of the Commercial and Financial Rand. In the case of Lesotho and Swaziland, Financial Rand transactions with non-CMA members require prior approval of South Africa's exchange control authorities. In the case of Namibia, Financial Rand investments at banking institutions or on its stock exchange are permissible without prior reference to the central bank. Applications for other Financial Rand transactions are considered by Namibia's own exchange control authorities.

In terms of bilateral agreements between the government of South Africa and the governments of Swaziland and Lesotho, the relevant parties may exercise discretionary powers in respect of exchange control matters affecting their respective countries and not covered in the MMA or by the current exchange control provisions. Proper notification must be given to other members and precautions should be taken that no authorization is given for a transaction circumventing the exchange control provisions of the other contracting party.

Repatriation and currency deposit arrangements

The contracting parties shall permit through normal clearing systems the repatriation of notes and coin issued by them which may circulate in another

CMA country. The central banks of Swaziland, Lesotho and Namibia all maintain current accounts with the South African Reserve Bank to which proceeds of the repatriation of rand currency to South Africa are credited on a regular basis.

Currencies of the three countries collected in South Africa can be converted into rand in South Africa by authorized dealers, who have been appointed as agents by these countries. The central banks of the three countries are prepared to repatriate their own currencies against rand, for which purpose drawings may be made from the current accounts mentioned above.

Any rand currency surpluses held by the mentioned central banks, after taking account of rand commitments, may be placed in the South African capital and money market or be used to purchase foreign exchange in the South African or other foreign exchange market. Payments and transfers for current international transactions and the conversion of current balances for this purpose are not restricted by the arrangements.

In addition to the current accounts held with the Reserve Bank by Swaziland, Lesotho and Namibia, Lesotho and Namibia also maintain special rand deposit accounts with the Bank, as well as call deposit accounts with the Corporation for Public Deposits. Both are interestbearing deposits calculated according to an agreed formula.

These additional deposits are used partly as cover against the aggregate amount of own currency issued by the central banks of Lesotho and Namibia. In terms of bilateral agreements between South Africa and these two countries, their central banks must maintain a reserve equilavent to the amount of own currency issued. This reserve can be in the form of rand assets and freely usable foreign currencies in such proportion as these banks consider appropriate. The rand assets used for reserve purposes shall consist of:

- The rand currency held by the central banks; plus
- the total rand deposits held by the respective central banks in the three accounts mentioned above; plus
- South African Government stock and Treasury bills held by the two central banks.

Compensatory payments

The government of South Africa must, in terms of the provisions of the MMA, make compensatory payments to other contracting parties, which payments shall represent an imputed return on the rand currency circulating as legal tender in their areas. This compensation is based on the assumption that these countries could have earned an income if the amount of rand circulating in their areas was issued by themselves and fully invested in income-generating assets.

Payments are made annually on the last business day of February of each succeeding year, covering the twelve-month period ending on 30 June of that year.

Such payments are made in rand and the relevant amounts due are calculated in accordance with an agreed formula as follows: two-thirds of X per cent of Y, where X represents the average annual yield to redemption of domestic South African Government stock with an outstanding maturity of 15 years or more for the months of October, November and December immediately preceding the annual payment date, and Y represents an estimated amount of rand notes and coin in circulation in the relevant countries, as agreed upon between the government of South Africa and the governments of other countries in the CMA, and calculated in terms of a prescribed formula, based on an estimated reasonable total for the average amount of notes and coin in circulation per head of the population of each country.

In 1986, Swaziland suspended the use of rand as legal tender and has since not been entitled to any payment in terms of this arrangement. Lesotho has received annual payments ever since the first RMA agreement was signed in 1974. Since 1980, however, the total estimated notes and coin issued by the Central Bank of Lesotho used in the above calculations has been reduced by the amount of maloti notes and coin issued by the Central Bank of Lesotho. Namibia acceded to the MMA in February 1992 and received its first compensatory payment on 28 February 1993. As, in September 1993, this country started to issue its own currency, namely the Namibian dollar, the estimated notes and coin in circulation in Namibia used in the calculations will in future also have to be reduced by the amount of Namibian dollars in issue.

It should also be mentioned that the former independent states in South Africa, namely the Transkei, Bophuthatswana, Venda and Ciskei, have also received annual compensatory payments since independence, calculated on the same basis. With their reincorporation into South Africa this will now fall away.

Collection and exchange of monetary statistics

The contracting parties in the MMA must cooperate with each other in the collection and prompt exchange of required statistical and other data for the effective administration of the agreement and for the formulation and implementation of monetary and exchange control policies.

Consultation procedures

To facilitate and ensure the continued compliance with the MMA and with a view to reconciling their different interests in the formulation and implementation of monetary and foreign exchange policies for the CMA, the contracting parties hold regular consultations.

For this purpose, and for any other matter arising from the MMA, a Common Monetary Area Commission was established. Each member of the MMA is represented on the Commission by one representative and such advisers as it may appoint. Decisions of the Commission are by consensus.

In terms of the MMA, the following rules, *inter alia,* apply to this Commission:

- It will convene regular sessions, at least once in every year, or whenever requested by any member country.
- Business referred to it should be attended to as quickly as possible.
- It should try to find solutions to members' satisfaction in respect of all matters referred to it.
- It should determine its own procedures, including the establishment of committees as required.

If prior consultations through the Commission are not possible a member should notify other contracting parties as far as possible in advance of any change in its monetary or foreign exchange policies, including any amendments to exchange control provisions. Should such notification be impossible because of the nature of the matter, parties must then be notified immediately after such change has been effected.

If bilateral consultations are to take place the remaining parties should be informed in time for the consultations and the relevant report should be laid before the Commission at its next meeting.

Settlement of disputes

Should any dispute arise between any of the contracting parties concerning the interpretation, application or conditions of termination of the MMA, every effort should be made to settle the dispute amicably and in good faith. If that is not possible the dispute should be submitted to an arbitrary tribunal which will be appointed and which will perform its functions in terms of agreed procedures and rules.

8

CREDIBLE ROADS TO EMU

*Jürgen von Hagen**

INTRODUCTION: THE FOUR IMPERATIVES OF CREDIBILITY FOR EMU

With an end, in August 1993, of the "New European Monetary System" (EMS), the attempt to maintain narrow exchange rate bands around fixed parities without the protection of capital controls,[1] the European Union's (EU) strategy for European Monetary Union (EMU) devised in the Maastricht Treaty, finally proved to be a failure. It had rested on three basic elements: a master-plan, featuring a timetable for the beginning of EMU; numerical entry criteria for participation in EMU and the gradual tightening of the exchange rate constraint in the Exchange Rate Mechanism (ERM) of the EMS; and the assumption that European voters would accept a scheme conceived by their governments, despite the large degree of uncertainty about the final shape of EMU.

That the Maastricht master plan was risky and fragile had been pointed out by economists soon after the publication of the Delors Report and the Maastricht Treaty.[2] A year later, one may state with relief that the widespread fear of very unstable exchange rate movements (Thygesen 1994) or a return to competitive devaluations in Europe (Eichengreen and Wyplosz 1993a) was unfounded. Exchange rate volatility has remained surprisingly small in Europe. That the European public was unwilling to go along with a master-plan leading to some uncertain end became clear in the bumpy process of ratification of the treaty.

One year after the demise of the Maastricht strategy for EMU, Europe has not agreed on a new approach to achieve monetary union. Taking a naive view of the Treaty, one might argue that there is no need for a new strategy at all. The simple way out is to define the new exchange rate bands of 30 per cent as "normal" and pretend that nothing has happened. Judging from the public debate over EMU since Maastricht, however, this simple way provides no remedy. There seems to be little faith now in the commitment of the member states to the other critical elements of the master-plan, notably the numerical entry criteria regarding fiscal policy. A general effort to meet these criteria would push Europe into a severe recession (Buiter *et al* 1992; von Hagen and Lutz 1995), a cost that governments are unlikely to accept. In view of that, the timetable set in Maastricht has lost credibility, too. Moreover, the bumpy ratification process, including the claim made by the German Supreme Court that Germany can withdraw from the process at the last minute, has cast doubts on the public's willingness to accept EMU, as well as on the desirability of the entire project.

But the other extreme solution, trashing the entire project, seems equally unlikely. A new strategy for EMU must, therefore, be found. To be credible, it must obey four imperatives:

- presenting an economically and politically desirable monetary union as the goal;
- gaining public support;
- facilitating credible commitment to price stability and coordination of monetary policies; and
- providing sufficient flexibility to accommodate different economic and political demands of the EU countries on the road to EMU.

This paper discusses some aspects of these imperatives. The next section sets the stage, arguing that a return to fixed exchange rates is not a necessary condition for the achievement of EMU. The following section discusses alternative designs of the future EMU and the problems connected with choosing among them. A further section considers the relationship between the EMU and political union in Europe. The final section draws the conclusions for credible roads to EMU.

HOW IMPORTANT ARE FIXED EXCHANGE RATES ON THE ROAD TO EMU?

Preoccupation with exchange rates has a long tradition in European integration.[3] Both the Treaty of Rome and the Maastricht Treaty define EU exchange rates a "matter of common concern" (Art. 103). While that does not mandate fixed exchange rates, it suggests that any approach to EMU must give an answer to the above question.

The Maastricht Treaty was based on the assumption that the road to EMU must lead by way of fixed exchange rates. However, there is no compelling economic theory backing that assumption.[4] Monetary union and fixed exchange rates are different systems with different transmission mechanisms of monetary impulses. Convergence of inflation rates, which plays a large role in the Maastricht strategy, is a valid concern for the viability of fixed exchange rates but not for the viability of monetary union. It is a well-documented fact that regional differences in inflation rates can be very pronounced in existing monetary unions. There is no good reason why the EU countries could not switch immediately from flexible rates to a monetary union.[5]

The desirability of a tight exchange rate constraint on the way to EMU must, therefore, come from another source. The breakdown of the New EMS provides a telling example of the relevant debate. Two explanations have been offered. One argues that the EMS was destroyed by cynical speculators in spite of sound fundamentals (Eichengreen and Wyplosz 1993b). If so, a speedy return to tight exchange rate constraints is advisable, and these should be backed up by the reintroduction of some capital controls. The other relies on fundamentals and argues that the New EMS was an inappropriate monetary framework for Europe. On that basis, exchange rate flexibility should be preserved.

Advocates of the first argument make their point based on the observation that inflation rates and interest rates converged in the EU in the early 1990s. Figure 8.1a shows that inflation differentials relative to Germany had indeed become small in 1991–2 in the EMS, the exceptions being Spain and Portugal. They seemed to indicate that there was no need for a realignment and that the prevailing central rates were credible.

However, looking at inflation differentials alone neglects the base effect of the exchange rate peg—i.e., the fact that cumulative inflation differentials rise and competitiveness deteriorates in the process of inflation covergence with a fixed exchange rate. Figure 8.1b indicates that substantial

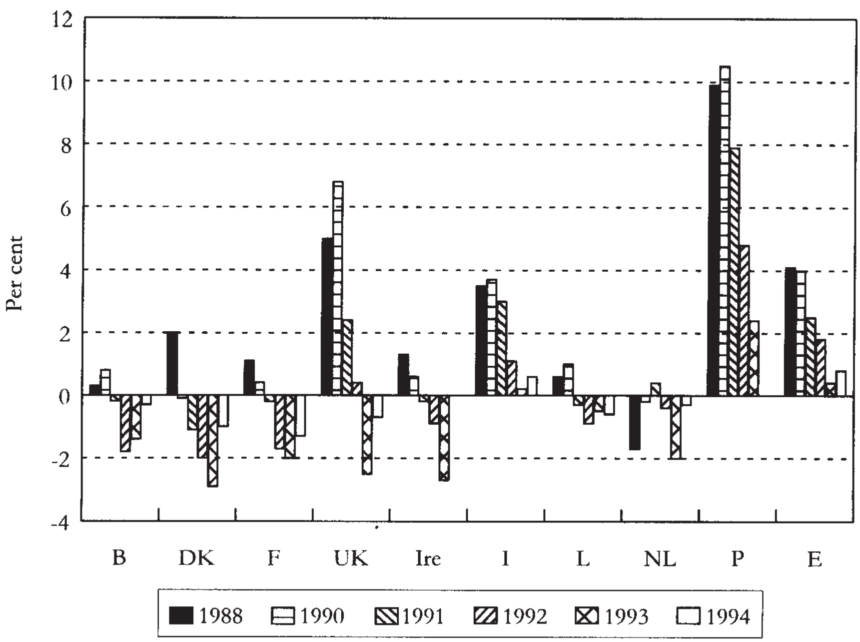

Figure 8.1a Inflation differentials with Germany

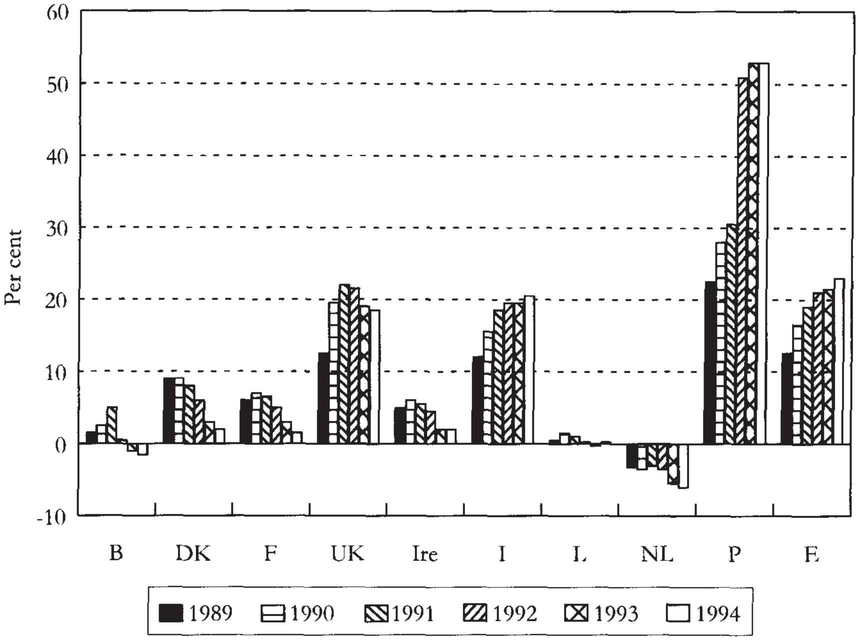

Figure 8.1b Cumulated inflation differentials

cumulative inflation differentials existed in the EMS at the time of the first crisis in 1992.[6] It shows that the exchange rate peg had created substantial relative price distortions, even while inflation rates were aligning in the early 1990s.

Even in the absence of large cumulative inflation differentials, convergence of inflation rates would indicate compatibility of the fundamentals with fixed exchange rates only if all countries under consideration were at the same stage of the business cycle. Figure 8.2 shows that this was not true in the EMS in the early 1990s. Denmark, France, Britain and Italy all had much lower real growth than Germany. In sum, the fundamentals were not right for fixed rates in the early 1990s.

Standard open-economy macroeconomics suggest that the New EMS itself was very much a part of the problem. The post-unification surge in German aggregate demand caused a steep rise in German interest rates requiring a real appreciation of the deutschmark. The EMS constraint forced Germany's partners to raise their interest rates through a monetary squeeze. Given their stubborn refusal to realign parities, the real appreciation required prices elsewhere in the EMS to fall relative to German prices—i.e., a higher German rate of inflation and/or a drop in the rate of inflation elsewhere. With the Bundesbank's unwillingness to accept higher German inflation, this could

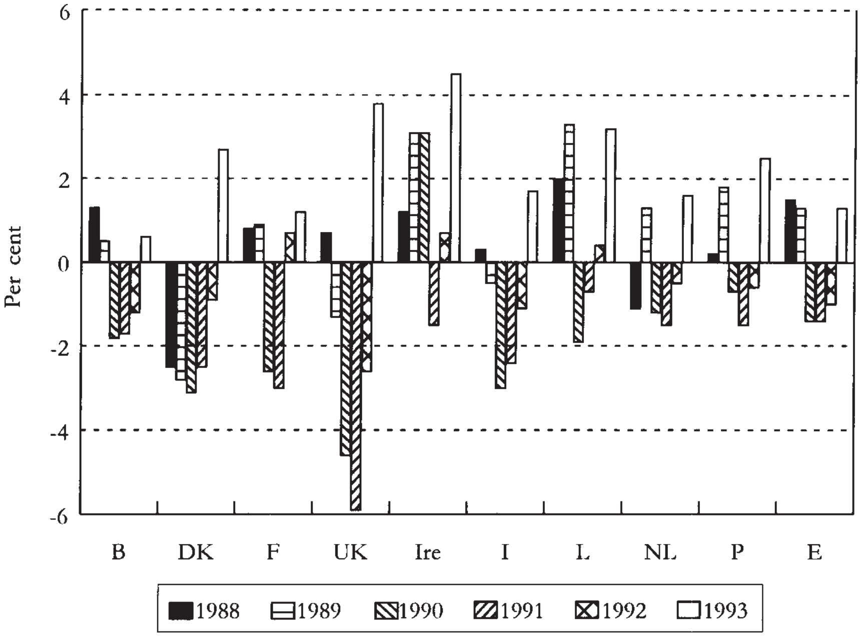

Figure 8.2 Real growth differentials with Germany

only be achieved through a recession in the other countries. The New EMS turned Germany's boom into recession everywhere else.

Its breakdown occurred when governments in the other countries were no longer willing to trade elusive credibility gains from pegging their exchange rates for rising unemployment and shrinking real growth. Thus, it was the product both of economic fundamentals and political preferences shifting away from fixed rates.[7] As Ozkan and Sutherland (1994) show, speculative trading may have precipitated this breakdown but speculation did not destroy an otherwise viable system.

We conclude that there is little reason to argue that self-fulfilling speculative attacks were a problem in the EMS. Figures 8.3a and 8.3b show how EMS exchange rates developed since the breakdown. The core group of France, Denmark, Belgium and the Netherlands experienced mild and temporary devaluations. The other countries experienced more lasting devaluations, but still there is no evidence of erratic movements. The evidence merely confirms the view that realignments were required to bring the system back into balance. At the same time, the post-1992 economic trends shown in the previous figures suggest that the EMS returned to a more balanced fundamental position in 1993 and 1994—that is, flexible exchange rates prevailed once more.

Overall, then, our interpretation and the empirical evidence lend no support to the view that exchange rate movements were distorted by

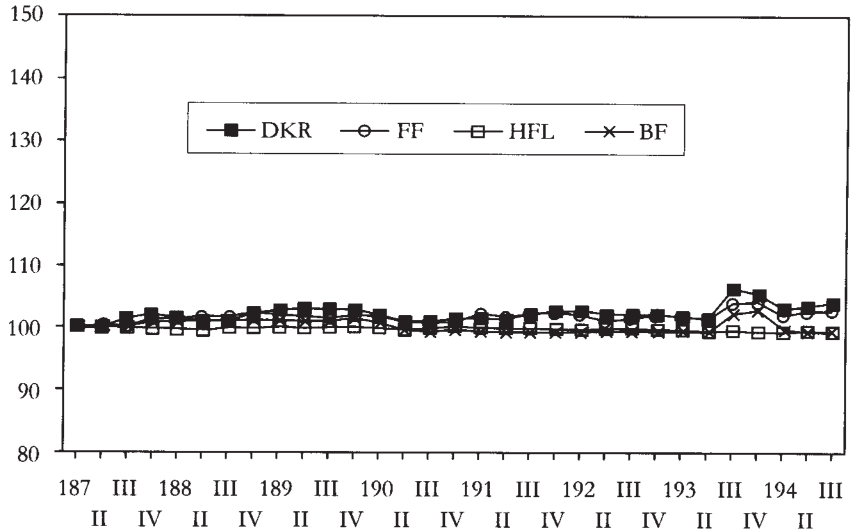

Figure 8.3a ERM exchange rates

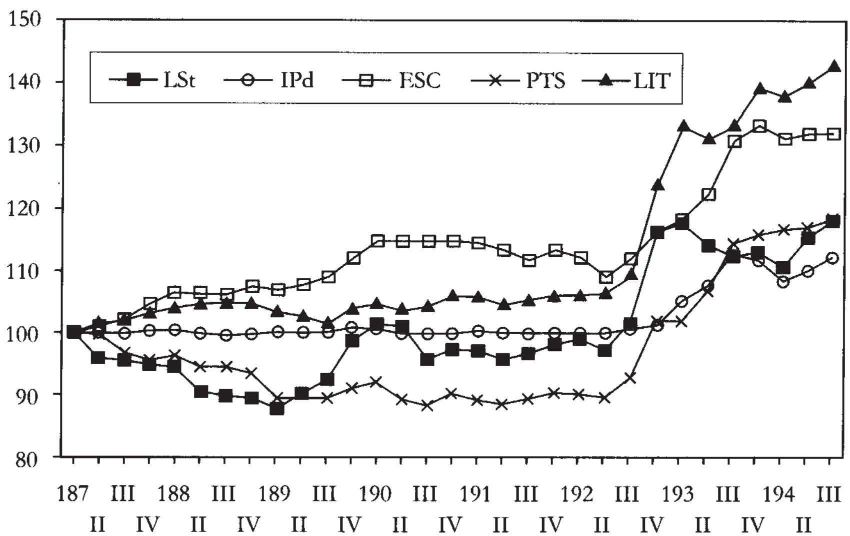

Figure 8.3b ERM exchange rates

irrational speculation implying that greater exchange rate flexibility would be harmful for European trade. Nor have European governments succumbed to the temptation of competitive devaluations.

Some fear that even in the absence of large exchange rate swings, trade and investment flows could be distorted by misalignments of flexible exchange rates. According to this view, markets somehow over—or undervalue currencies for protracted periods of time. But admitting that to be possible does not justify a tight exchange rate system unless the system managers knew the correct valuations and had their hands free of political constraints to enforce them. The fate of the EMS suggests that there is no reason to expect that. In sum, a return to a tight exchange rate peg is not an urgent constraint for a new strategy for EMU.

There is reason to believe, however, that a tight exchange rate peg would be very inappropriate for Europe in the next decade. Despite the widespread agreement today that price stability should be the principle goal of monetary policy, the most important reason why the EU today is not an optimum currency area is that there is still fundamental disagreement over basic principles of economic policy. Most of all, this concerns the proper role of government in the economy. Current views range from active involvement in many economic spheres to non-interventionist government committed to competition. The Maastricht Treaty itself invites the undermining of the Single Market by activist European industrial policies, an aspect of the Treaty that has contributed much to its negative reception by the public in Germany and Britain.

Until recently, such fundamental disputes in the EU were covered up rather than resolved. When disagreement surfaced the EU ended up with new plans for more ambitious integration. The external threats (military from the East and of economic dominance by the USA) demanding EU solidarity and, internally, the non-tariff barriers to trade sheltering markets from EU competition even within the customs union facilitated this tendency.

The post-Maastricht policy environment is fundamentally different. External threats have receded and the Single Market is doing away with remaining internal trade barriers. This new environment will intensify international competition of economic policies. In the Single Market, consumers, investors and workers will increasingly decide for themselves, by choosing between goods, investment opportunities and places to live and to work, which type of politico-economic system they prefer. Governments will have to adjust old policies to the public's demands. The ensuing changes in labor markets, tax and subsidy structures, regulation, or social policies will create relative price, income and wealth shocks between the EU countries. Thus, introducing the Single Market will increase the very type of shocks for which fixed exchange rates are unfit. This suggests that preserving the current degree of exchange rate flexibility is more appropriate in the run-up to EMU.

ISSUES IN THE DESIGN OF EMU

The notion of EMU is compatible with many different financial and monetary environments. The Maastricht Treaty, in fact, contains only vague stipulations with regard to important aspects of the financial markets environment and the implementation of monetary policy in the EMU. Instead, it left these decisions to the European Monetary Institute (EMI) and the European Council. Among them are the choice between a multipleand a single-currency EMU, the choice of a degree of money market integration, the decision as to what extent central bank operations and the regulation of the banking industry will be centralized and harmonized, and the formulation of monetary policy objectives in the EMU. A review of the EU today reveals that there is no consensus in these regards. Yet, these decisions impose requirements on regulatory provisions and barriers to market integration and carry important welfare implications.

Once its operation has begun, the European Central Bank (ECB) must formulate and implement a monetary strategy—that is, state policy objectives and devise ways to achieve them. One way to define monetary policy objectives for EMU is to adopt union-wide aggregates of prices and income as the target variables for monetary policy. For example, the ECB objective of “price stability” could be defined as a zero or small increase in the European price level—i.e., the cost of a European commodity basket. Alternatively, the ECB could set targets for the individual national aggregates and derive the union objective simply from adding these up to an EU average.

These two approaches have different political economy implications. A decentralized approach makes inflation differentials and, consequently, the distribution of the adjustment cost to relative price changes explicit objects of policy choice. Consider a real shock demanding a relative price adjustment. To achieve price stability in Europe, prices must fall in some countries relative to others. With a decentralized objective, in order to assure EMU price stability, the ECB would have to announce a deflationary policy for some countries. One may reasonably expect that the public and the governments in these countries will perceive that they are bearing a larger burden of adjustment and will put political pressure on the ECB for a non-deflationary policy. The monetary authorities will find it hard to resist such pressure and will try to avoid national inflation targets of zero or below. In any case, to make EMU inflation consistent with regional inflation differentials, the decentralized approach is likely to produce higher EMU inflation than a centralized one. Alternatively, the central banks may try to enforce equal rates of price change in all parts of the union—that is, to force the economies to adjust through quantity changes rather than relative price changes. The real performance of the EMU will then be worse with decentralized than with centralized policy objectives.

A similar choice between centralization or decentralization arises for the regional structure of central bank operations in the EMU. In a centralized setting, all monetary operations are delegated to a single institution. In a decentralized setting, in contrast, monetary operations are conducted by different central banks. If decentralized operations are oriented at a single union operating target, such as a short-term interest rate, close coordination and continous mutual information among the central banks are necessary to avoid policy errors. In contrast, coordination and mutual information are less important if a sufficient degree of market segmentation assures a stable link between national central bank actions and national operating targets and limits policy spill-overs into other markets.

Furthermore, while a centralized policy objective can be pursued with centralized or decentralized operations, decentralized objectives require decentralized operations and, therefore, a minimum degree of market segmentation. Finally, a multi-currency MU seems a more natural setting for decentralized objectives. To assure a reliable link between national monetary aggregates and policy targets, this also would require a minimum degree of segmentation in the deposit markets to limit currency substitution.

Agreement on a common, union policy objective and centralized operations would be facilitated if the national central banks already followed similar strategies today. However, this is far from true. EU central banks today are variations of two basic models. The *Bank of England model* is a central bank conducting mostly outright purchases and sales in the domestic open market and almost no direct transactions with domestic banks. The *Bundesbank model* is a central bank engaged almost exclusively in lending and other operations with domestic banks. Reserve requirements are also of varying significance. Finally, central bank involvement in banking regulation varies considerably, too, as does the central banks' role in deposit protection. Garber and Weisbrod (1990) and Folkerts-Landau and Garber (1992) point to the importance of the central banks's lender-of-last-resort function in financial markets with high degrees of securitization. The need for a lender-of-last-resort varies substantially in the EU, since the UK today has a high degree of securitization, while Germany maintains a low degree, and France and Italy have recently moved towards more securitization.

Three scenarios for EMU

To explore the broad menu of choices in the dimensions of financial market environment and decision-making structures available for EMU, consider the three basic scenarios outlined in Table 8.1. Scenario I is characterized by union policy objectives, centralized operations, a single currency and a high degree of money market integration. Regulatory standards would be uniform in the EMU but could be set relatively low. Scenario II is

Table 8.1 Three scenarios for EMU

Scenario	*Policy target*	*Operations*	*Currencies*	*Market integration*
I	EMU	Centralized	Single	Full
II	EMU	Decentralized	Single	Medium
III	National	Decentralized	Multiple	Low

characterized by EMU policy objectives, decentralized central bank operations, one currency and a medium degree of money market integration. It resembles the proposal of the Delors Report (1989). Neither the use of national policy instruments nor banking regulation require intense coordination. In Scenario III, national policy objectives prevail, with decentralized central bank operations, multiple currencies and minimal degree of money market integration. This is just a tighter version of the New EMS; it largely preserves the status quo: national central banks would remain almost intact and maintain their traditional ways of monetary policy.

The welfare implications of these scenarios are illustrated in Figure 8.4. The figure shows that there is a trade-off between expected welfare gains and uncertainty in the choice of a design for EMU. Scenario I maximizes market integration and minimizes the need for money and capital market distortions. In this sense, it maximizes EMU market efficiency and, among the three scenarios, is best in an expected welfare sense. However, scenario

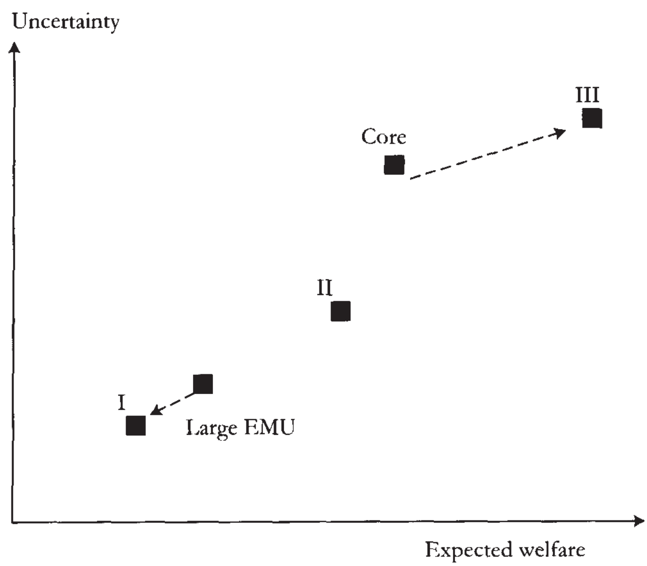

Figure 8.4 Scenarios for EMU

I pairs high expected welfare with large uncertainty, at least in the early phase of the EMU, as there would be little reliable information about the empirical links between central bank instruments, operating targets and union policy objectives.

Scenario II implies a lower degree of market integration and, therefore, produces a lower expected welfare level than scenario I. But it also yields less uncertainty, since the existing links between central bank instruments and operating targets remain largely intact. The main additional source of uncertainty regards the link between operating targets and the union policy objective. Scenario III, finally, yields the lowest expected welfare level but minimizes uncertainty relative to the status quo.

One might suggest that, in order to reduce initial monetary policy uncertainty in the EMU, the EU should adopt an arrangement like scenario III at first and proceed to the most efficient one later on. However, scenario III offers very little to learn about scenario I, since it would preserve market segmentation and, therefore, impede the very learning processes necessary to discover the empirical link between a single European currency, the central bank instruments for its control and a union policy objective. Instead, the inefficiencies implied by scenario III would only keep the public from enjoying the benefits of a fully integrated currency area and diminish political support for EMU in its early phase.

The comparison indicates that a risk-neutral decision-maker would adopt scenario I—the more risk averse he/she is, the more likely he/she would be to adopt the third scenario. This implies that "conservative" decisionmakers would most likely prefer scenario III. Here, the role of the EMI could be critical. Dominated by central bankers who will tend to favor conservative, status-quo-biased solutions, the EMI may bias the process towards the inefficient scenario III.

The European choice of a particular scenario for EMU will depend heavily on the solution to the membership question which the Maastricht Treaty left open. A core group of central banks in the EU—Belgium, Germany, Luxembourg, the Netherlands and, since the mid–1980s, France—have built reputations as central banks committed to price stability in the past. They will be reluctant to give up their brand names and join in a scenario I-type EMU which includes low-reputation central banks in Europe. As long as the membership question is unsolved and the latter have a reasonable chance to join, this core group will prefer solutions that retain a maximum degree of autonomy and the option to dissolve the EMU at a relatively low cost—i.e., one with decentralized objectives and operations, multiple currencies and a low degree of market integration. Thus, the most efficient EMU is more likely the more membership can be restricted to the core group.

Obviously, the non-core members of the EU will not accept such a solution readily, since they stand to gain relatively more from a fully integrated EMU which includes all EU members. It seems unlikely that those members could override the opposition of the core group to this solution in the EMI council. However, it is equally unlikely that the core group can get a majority in favor of a small EMU through the EMI council. As a result, the core group will settle for an all-EU EMU as characterized by scenario III. Unless the decision-making process is framed in a way that allows for a core EMU, the conflict of interest between the core group and the remaining countries reinforces the EMI's bias for an inefficient EMU.

MONETARY UNION, POLITICAL UNION AND ENLARGEMENT

The main driving force behind monetary integration has always been the desire to use a common currency as a stepping stone to an (otherwise deemed impossible) European Political Union. The connection between political and monetary union is, therefore, an important aspect in judging the credibility of EMU.[10] Today, however, European Political Union is an even less well-defined product than EMU. Historically, France favored political union in the hope of becoming a dominant European power while, at the same time, keeping Germany firmly tied to a Western Political and military alliance.[11] German politicians, since the Second World War, to safeguard peace with France and to regain international clout have pursued political integration. German unification may have reduced that aspiration to some extent. But, today, German politicians press for political union in Western Europe because they fear that Germany might be left alone in the face of rising political and economic instability in Central and Eastern Europe. They see tying German into a European political union as a way to secure her partners' involvement in spheres East of Germany (CDU, 1994). The political union both Germany and France envision would have a strong political center allowing these two countries to enjoy their dominance in the region.

Some other European nations now seem to view political union as a strategy to resolve internal, regional conflicts. Integrating into a European union may be an attractive strategy for Catalonians, say, to reduce the influence of Madrid. Similar arguments can be made for regional movements in Italy and Belgium. But the political union envisioned by these regionalists is a decentralized one with no strong political administration.

Finally, as witnessed by the debates over the ratification of the Maastricht Treaty, political union seems completely unattractive for at least two countries in the current EU: the UK and Denmark.

This diversity of interests in political union is a vital question for EMU and one particularly critical with regard to Germany. The German position before Maastricht and since then, indeed, even the position of the German Supreme Court, was to emphasize the need for political union to complement monetary union. Since Germany stands to gain little if not to loose from monetary union, Germany's willingness to pursue EMU rests on the prospect of getting political union in return. If the latter turned out to be unachievable German participation in EMU is questionable and, with it, the entire EMU project.

European integration has proceeded historically in successive waves of deepening and enlargement. Sticking with the Maasticht strategy, this pattern would continue: following the enlargement of the mid–1990s, EMU would be completed before membership of the emerging market economies to the East of the EU is considered. But enlargement and monetary union are interdependent for at least two reasons: first, the enlargement of the 1990s may affect the shape of the monetary union; second, monetary union may inhibit the integration of Central and Eastern Europe into the Community.

All three new entrants, Austria, Sweden and Finland, are close to satisfying the entry conditions for EMU laid out in the Maastricht Agreement. Austria would join as an immediate member of the core group; the others would be closer to this group than to the periphery. Assuming that Denmark and the UK remain outside of EMU, the number of countries in the current EU necessary to form a majority for EMU purposes is six (of ten), one more than the core group. With the enlargement, however, the required majority is eight of fourteen (seven of thirteen without Norway). The core group plus Austria and two new members could form such a majority. EU enlargement raises the probability of a core-EMU that could start relatively early.[12]

The other link between enlargement and monetary union concerns the future membership of the countries East of the EU. As noted by Baldwin (1994), the successive waves of deepening and enlarging the Community have made entrance increasingly more difficult for new candidates as time has passed. Adding EMU to the Single Market will make the hurdle much higher for the emerging market economies and delay for a long time their chances of joining the EU. Such delay, however, is not without a price. Not unlike integration of the Southern periphery in the 1980s, early integration of these countries is commonly viewed as important to secure their fledgling democracies and, hence, as an important part of securing peace in Europe. Keeping the entry barriers surmountable carries substantial political weight for the EU.

This leads us back to the link between monetary and political union. A political union encompassing the new entrants of the 1990s and the future entrants to the East would dilute the influence of France and Germany in the union and reduce their interest in political union. The other current members of the EU will equally shy away from political union with East and Central Europeans, given their political uncertainties and instabilities. Yet, if all new entrants must subscribe to EMU their participation in political union could not be reasonably excluded. Political union in Europe would thus be delayed or even inhibited. This, again, would lower Germany's interest in EMU. Thus, insisting on a general membership of all Europeans in EMU could become a self-inhibiting strategy.

CREDIBLE ROADS TO EMU

Our discussion carries three main messages under a common theme. The theme is that it is simply impossible today to answer with certainty all the questions regarding EMU left open by the Maastricht Treaty and to find a design that meets the interests of all parties involved. Three main implications follow from this:

1 Another *grand schème* engineered by politicians, such as the Maastricht road to EMU, will lack credibility for lack of democratic support.
2 In view of the diversity of interests in the existing and the developing EU, a credible road to EMU requires the possibility that countries make different choices fitting their different demands. Above all, this includes the choice not to participate in EMU temporarily or at all and yet be a member of the Single Market and other areas of European integration.
3 The EU needs room for competing policy approaches and trial-and-error to reduce the uncertainty over what is an adequate framework for European economic policies.

In sum, a credible strategy for EMU needs flexibility. This rules out the swift return to a tight exchange rate constraint. Furthermore, announcing on all-EU EMU to begin within the next decade lacks credibility as it is unlikely that all EU members will wish to join when the day of reckoning comes. Announcing on all-EU EMU with no deadline lacks credibility, as it pushes the beginning of EMU into the far future. Thus, a credible strategy for EMU rests on a Europe of two (or more) speeds.

This leaves essentially two options: to begin EMU immediately and leave it up to each EU member state to join or abstain, or to begin a transition phase now which some member countries can use to prepare for EMU.

De Grauwe (1994) has presented a proposal for the first option. The EU would declare EMU to begin immediately and let all countries decide whether or not they wish to be members. Those who do would adopt a common currency at once. Those who do not, remain on flexible exchange rates or maintain wide exchange rate bands with the others until they wish to join.

The weakness of this proposal is to make the decision over EMU the result of an uncoordinated voting game among the EU members. Such a game is unlikely to yield efficient outcomes, because of the externalities involved in EMU. Specifically, the attractiveness of EMU for each potential member depends largely on who the other members of the group are. Since

Germany is keen on keeping the size of EMU limited (De Grauwe 1993) Germany's incentive in this game is to keep her participation uncertain until the last moment. This, in turn, will induce her neighbors to keep their participation open, as the attractiveness of EMU for them depends largely on German participation. The resulting uncertainty over the composition of the group will bias the decision against participation, even if all potential members would like to go ahead with an efficient core-EMU in the absence of membership uncertainty.

Fratianni *et al.* (1992) have presented a proposal for the second option. It takes a more evolutionary approach to EMU, based on the "Two-Tier EMS." The Two-Tier EMS would keep the commitment to the current, wide exchange rate bands to provide sufficient protection against large exchange rate shocks. Within these bands, the participating central banks would be free to define narrower exchange rate bands with other currencies as they see fit and as unilateral, non-compulsory commitments. With no obligation to sell reserves at the margins, these narrow bands will not be exposed to speculative attacks.

The Two-Tier EMS could serve as a framework for flexible policy coordination. If a currency leaves its narrow band for more than, say, three consecutive days, mutual consultations within the EMI would be called to find adequate solutions. Changes in the narrow bands, as indeed changes in the wide band, would not affect the credibility of monetary policy, as the public would regard them simply as responses to asymmetric shocks. The Two-Tier EMS would, thereby, have the flexibility required for the transition to EMU. This much has already been achieved by the crises of the New EMS.

Three more conditions are necessary to complete the Two-Tier EMS. First, to make the national monetary authorities independent from government and short-term political orientation, an important condition for credible commitment to price stability. These central banks would be held accountable by a firm mandate to achieve price stability. Second, to vest the independent central banks with the responsibility for exchange rate policies. The common institutional basis of central bank independence would assure price stability for the EU. Third, to implement, as required by the Maastricht Treaty, government budgeting procedures conducive to fiscal stability.[13] Concluding a review of budgeting practices in the EU, von Hagen and Harden (1994) recommend the institution of independent National Debt Boards in each member state. The National Debt Boards would have the authority to determine the maximum change in general government debt for each year, leaving the decision on total public spending for the governments and the parliaments.

These institutional reforms will benefit the participants regardless of their later participation in EMU. Therefore, they constitute credible commitments on the road to EMU. The EMI's role here would be to watch and comment on the development of monetary and fiscal institutions in the EU.

Over time, competition among national economic policies would make some or all EU members converge on similar sets of policies and domestic institutions. These countries would find that policy-induced asymmetric shocks peter out and changes in their mutual narrow bands become increasingly rare. They would be free to agree on monetary union among themselves when they are ready for it.

The main differences between De Grauwe's proposal and ours are, first, that the Two-Tier EMS buys time for institutional and policy adjustment, and, second and more importantly, that the Two-Tier EMS resolves the externality problem involved in the voting game. The Two-Tier EMS would serve as a filter mechanism to determine the core group of countries to start EMU. Exchange rate policies in the Two-Tier EMS would signal a country's readiness and willingness to join the core EMU, leading to EMU through a smooth transition of flexible cooperation.

Once a core-group EMU is formed, it could maintain a low-inflation policy without concern about its effect on the slow-track countries. But, the formation of the core EMU would be likely to raise the requirement of premonetary union policy adjustments for the latter and delay their entry to EMU. This concern was reflected in the deal struck at the 1992 Edinburgh summit: the periphery countries consented to opening membership negotiations with the new applicants—which, as argued above, makes the core EMU more likely—after the core countries had agreed to increase the EU budget, implying a broader scope for regional policies compensating the periphery for the delay of stage III. More generally, a credible road to EMU may require the possibility for deals among the core and the slow-track members to enhance the chances for an early, efficient EMU.

Opposition against a two-speed EMU stems from the fear that such deals might lead to a "Europe *à la carte*" with different obligations for different members (Martin 1993).[14] At first glance, the possibility of deals involving other areas of EU policies to settle on a particular EMU scenario does indeed look undesirable, as it seems to encourage EU members to engage in cherry-picking. Preventing such deals, however, may make it impossible to buy off the opposition against an efficient, core-group EMU and reduce the chances that Europe will get the best possible EMU in the forseeable future. Rejecting a two-speed EU will, therefore, only make the EMU project less credible.

Alesina and Grilli (1993) fear that the core group would never agree to enlarge the EMU once it started a small one amongst themselves. The EU would then be struck with an incomplete EMU. This risk can be reduced by lowering the gate-closing power of the early EMU members. One way to do that would be to extend the Two-Tier EMS as the framework of coordination among the core EMU and the slow-track countries. Furthermore, comprising both participants and non-participants of the core EMU, the ECB's General Council will assure that the latter have a voice in EMU matters even with a two-speed approach, which limits the probability that the core group could exclude them for ever. But even if the core group can keep the gates closed for some time and delay an all-encompassing EMU when the remaining countries are ready for it, this risk has to be weighed against the fact that insisting on a single-speed EMU today deprives the project of credibility and makes EMU unlikely for the forseeable future.

NOTES

*The author would like to thank Michelle Fratianni and Paul De Grauwe for valuable comments.

1 The "New EMS" began in 1987. The term was coined by Giavazzi and Spaventa (1990).
2 See, for example, Giovannini (1990), Fratianni and von Hagen (1990), Fratianni *et al.* (1992).
3 See Fratianni and von Hagen (1992) and Thygesen (1994) for reviews.
4 See De Grauwe (1994) for a discussion.
5 See De Grauwe (1994) for an extensive discussion.
6 Figure 6.2 calculates the differentials starting in 1987—i.e., after the last realignment in the ERM. Of course, for the UK, Portugal and Spain one must allow for the fact that these countries entered the ERM later than 1987.
7 Eichengreen and Wyplosz argue that the fundamentals-based explanation of the end of the New ERM fails because it fails to explain why the collapse occurred two years after the underlying shocks hit. Their criticism assumes that the public knows the preferences of the policy-makers perfectly and that the latter are constant.
8 See von Hagen and Fratianni (1993) for more details.
9 This was noted already by Triffin (1960). See Fratianni and von Hagen (1992) for a historical review.
10 It is widely accepted now that the economic case for EMU is small. Relying on the estimates of the European Commission—which is certainly free from the suspicion to understate the case in favor of EMU—the net benefits from EMU amount to 0.5 per cent of per capita incomes in the EU (Commission of the European Communities, 1990). To put this in perspective, the economic value of EMU for an average German amounts to the equivalent of 3.5 packs of cigarettes a month!
11 See Swann (1992) for a discussion.
12 See also Qvigstad (1992:22) and Baldwin *et al.* (1992:33).
13 See von Hagen and Harden (1994) for an analysis of budgeting procedures in the EU and a proposal for reform.
14 For example, the Danish government won four opt-out clauses in Edinburgh, for EMU, and for the common European policies in matters of defense, interior and law.

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9

EXCHANGE RATES IN SEARCH OF FUNDAMENTAL VARIABLES

Paul De Grauwe

INTRODUCTION

The behavior of the dollar exchange rates of the last few years has been perplexing in many ways. Not only has it turned out to be almost impossible to predict the movements of the dollar (something which is not really surprising); more importantly, the link between the dollar exchange rates and the "fundamental" variables (the money stock, the interest rates, the business cycle, etc.) has been very tenuous. For example, those who thought that there was some predictable relationship between economic activity and the dollar, or between the interest rate movements and the movements of the dollar rates, have found that this relationship is very unstable. In 1994, when the Federal Reserve started to raise the domestic interest rates and the Bundesbank initiated a policy of lower domestic rates, most analysts predicted that the dollar would increase in value. Exactly the opposite happened. Put differently, although many economists today have lost their ambition to forecast exchange rates, most of them would like to be confident in making *conditional* forecasts—i.e., to be able to predict what the dollar will do when, say, the money stock is reduced in the USA. It turns out that these conditional forecasts are as difficult to make as the unconditional ones. In this paper we try to explain this puzzling phenomenon of the weak link between exchange rates and the fundamental variables.

EXPLANATIONS FOR THE WEAK LINK

In this section we discuss some common explanations of the weak link between movements in the fundamentals and the exchange rate.

The news model

The most common explanation has been phrased along the following lines. We fail to correctly predict how the dollar reacts to, say, a change in the interest rate not because our models are wrong but because some other shock (news) has occurred in the meantime. In other words, in a complex world where news is hitting the market continously, the *ceteris paribus* hypothesis is almost never fulfilled. Thus, if we are unable to forecast correctly how the dollar would react to the increase in interest rates in the USA and the decline in Germany during early 1994, it is because at the same time other things happened.

This view is now the prevalent one. It leads to the following curious situation: each time a puzzling movement in the exchange rate occurs, analysts start a frantic search for some variable that has moved and that could account for the observed exchange rate behavior. Since the world is in continous movement, this search will always be successful. Some varible will turn out to have moved and will be declared by some analyst to be responsible for the puzzle. Reuters screens will then transmit this "explanation" to the whole world.

This view of how the foreign exchange markets function is unsatisfactory. In fact, it can be said that it has been refuted by much careful econometric analysis, starting with the work of Meese and Rogoff in the early 1980s.[1] Invariably, these studies reveal that whatever exogenous variables one cares to add to the underlying structural model, the prediction outside the sample period will be poor compared to simple predictions that do not use structual models.

The overshooting model

The *overshooting model* provides another explanation of why the exchange rates may appear to be unrelated to fundamental variables.[2] This model predicts that news about the fundamental variables necessarily leads to overshooting of the exchange rate. That is, the exchange rate must jump away from its fundamental value and will then go back to it slowly, at least if no new shocks occur. As a result, we will often observe movements of the exchange rate that appear to be unrelated to its fundamental value.

Clearly, this is not the way exchange markets work. We observe very little of this dynamics in which the exchange rate is disturbed and then goes back to its fundamental value. What we do find is that exchange rates tend to exhibit unit roots, indicating that the forces driving the exchange rate back to a unique equilibrium value after a shock are weak. The only way this overshooting model can be saved is by assuming shocks with enough frequency. As a result, the exchange rate will be observed to overshoot some constantly moving equilibrium value.

This view of the workings of the foreign exchange market is only superficially different from the conventional one discussed in the previous section and it suffers from the same problems. In fact, all the structural models exhibiting the overshooting dynamics have been refuted, using the methodology introduced by Meese and Rogoff (1984).

Speculative bubbles

A third way to explain the weak link between the exchange rate and the fundamental variables is by introducing speculative bubbles. There is no dount that speculative bubbles have occurred in the past. The problem with this explanation is that each bubble must be followed by a crash. And the simple fact is that one observes very few crashes. As a result, this theory cannot be seen as a general explanation of a phenomenon that occurs frequently. (There is the additional problem that the speculative bubble theories may be good at explaining why a bubble starts but it does not do well in explaining why a crash occurs.)

In this paper we present an alternative explanation as to why exchange rate movements appear to be dissociated so often from movements in fundamental variables. In order to do so, we present a non-linear model of the foreign exchange market. In addition, this model will be shown to be capable of mimicking other "anomalies" of the foreign exchange markets.

THE MODEL

The basic ingredients of the model are very similar to the celebrated Dornbusch model (Dornbusch 1976). A first building block is the money market equilibrium condition (money demand equals money supply). Second, open interest parity ensures that expected returns on domestic and foreign assets are equaled. The interest rate and the exchange rate adjust instantaneously so as to clear the money market and maintain interest parity. Third, in the goods markets, prices are sticky. In the long run, however, they adjust so as to make purchasing power parity possible. (The model is described in greater detail in the Appendix.)

The part where we deviate from the Dornbusch model is in the formulation of expectations. We assume two kinds of agents, "fundamentalists" and "chartists." The fundamentals compute the equilibrium (fundamental) exchange rate, which in the present model is the PPP value of the exchange rate. If the fundamentalists observe a market rate above (below) the fundamental rate they expect it to decline (increase) in the future. The rate at which they expect the exchange rate to return to its fundamental value is related to the speed at which the prices in the goods market adjust.

The "chartists" follow a very different rule. They do not use the information contained in the price levels to forecast the exchange rate. They base their forecasts on (more or less complex) extrapolations of past exchange rate movements. It is assumed that they do this following simple moving average models. (The detail of the behavior of the fundamentalists and the chartists is presented in the Appendix.)

The essential difference between the behavior of the fundamentalists and the chartists is that the former are forward-looking in forecasting the exchange rate, while the latter are backward-looking. It is this difference that drives most of the results of this model. We do not claim that the assumed behavior of fundamentalists and chartists is realistic. We use this assumption here to analyze how the interaction of agents using different bits of information affects the behavior of the exchange rate.

The central result of this model is that it is capable of generating a complex (chaotic) behavior of the exchange rate. (In De Grauwe *et al.* 1993 a more detailed analysis is provided.) Two aspects of chaotic behavior should be stressed here. First, the behavior is "aperiodic"—i.e., the model generates cycles in the exchange rate, each of which, however, is unique. Second, the behavior is characterized by extreme sensitivity to initial conditions (the "butterfly" effect). All this implies that the exchange rate will exhibit a very complex pattern, which cannot easily be predicted, despite the simple nature of the underlying model. Put differently, the knowledge of the underlying model and its exogenous variables will not help much in making good forecasts of the exchange rate.

We illustrate these features in Figures 9.1 and 9.2. These exhibit simulations of the exchange rate using the model described earlier and filling in numerical values of the parameters (see De Grauwe *et al.* 1993). The only difference between the two simulations is a small change (1 per cent) in the initial value of the exchange rate. Apart from this difference, the same model is used and the same (constant) values are given to the exogenous variables of the model.

We observe several features of the dynamics of the exchange rate

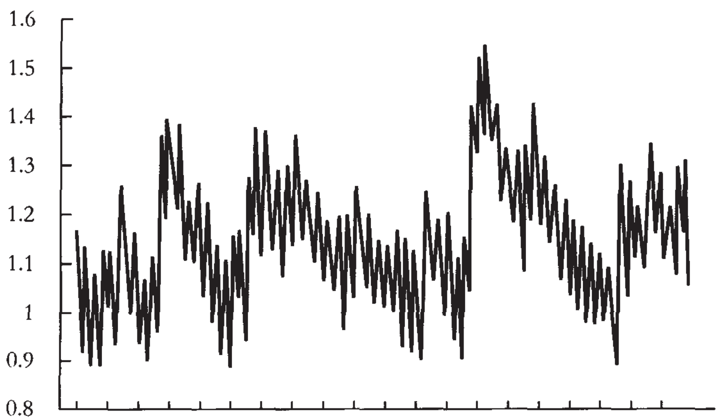

Figure 9.1 Simulated exchange rate

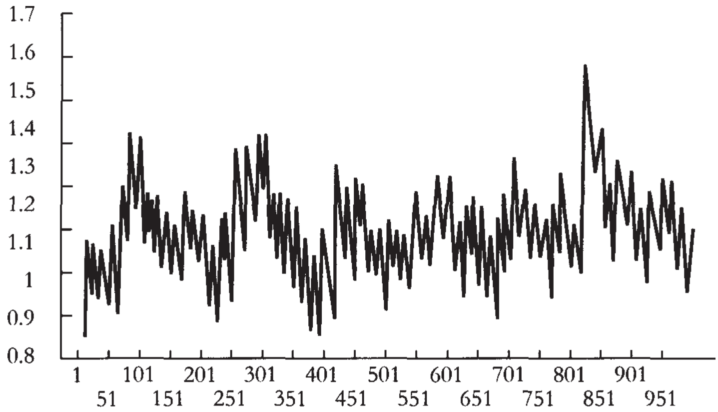

Figure 9.2 Simulated exchange rate (small difference in initial conditions)

Source: P.De Grauwe *et al.* (1993), p. 145

movements. First, these movements show a complex pattern with many "rallies" of the exchange rate in one or the other direction. Second, the movements of the exchange rate are unrelated to movements of the underlying fundamental variables, since these are kept constant all the time. It looks as if exchange rate movements have a life of their own. This feature comes from the speculative dynamics, in which some speculators use forward-looking rules and others backward-looking rules. Third, the sensitivity to initial conditions shows in the difference of the time pattern of the exchange

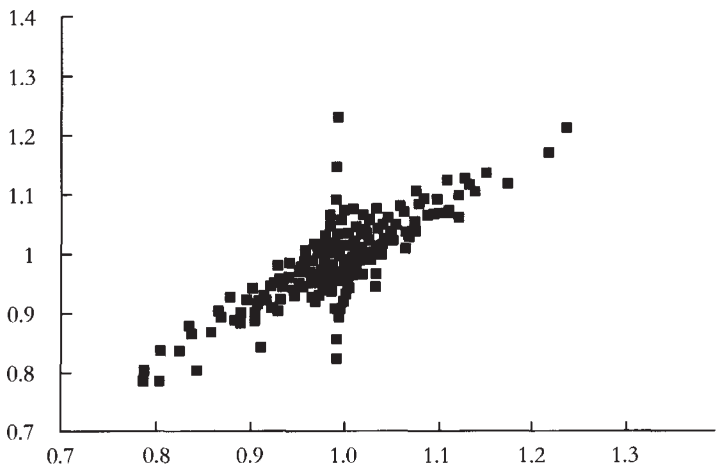

Figure 9.3 Phase diagram of the model in the s-s space

Source: P.De Grauwe *et al.* (1993), p. 136

rate in the two figures. We observe that small differences in initial conditions can generate a very different timing of the ups and downs of the exchange rate. Note, however, that these differences do not affect the qualitative nature of the exchange rate dynamics. (The latter shows up in the fact that the phase diagrams of the two time series in Figures 9.1 and 9.2 are identical. [See Figure 9.3]).

The preceding evidence suggests that a relatively simple "non-linear" monetary model is capable of generating a complex dynamics of exchange rate movements in which the latter, as a rule, are disconnected from the movements of the fundamental variables. This feature creates the impression that the exchange rate is continously shocked by news in the fundamental variables, although no news occurs. This result is related to the fact that the model does not have a unique solution. Rather it produces a "strange attractor," which defines the space within which the exchange rate moves in an erratic way.

In reality, news does, of course, occur. It is, therefore, interesting to analyze the workings of the model when shocks in the fundamental variables occur. There is another reason why news matters. As will be made clear in the next section, the movements in the fundamental variables affect the strange attractor and therefore the long-run movements of the exchange rate.

THE MODEL WITH "NEWS"

In this section we analyze the behavior of the model when stochastic shocks occur in one of the exogenous variables. We will limit ourselves to an analysis of "news" in the domestic money stock. Most of the results discussed in this section carry through when disturbances occur in other exogenous variables.

We assume that the stochastic process driving the domestic money stock is a random walk, and we feed this random walk into the model. As an example, we present the simulated exchange rate and the domestic money stock in the time domain in Figure 9.4.

As can be seen, over a time horizon of 1,000 periods, the correlation between the exchange rate and the domestic money stock (the fundamental) is quite close. A simple regression analysis confirms this (see Table 9.1). From this table we also find the theoretically expected value of the parameter of the money stock. This is equal to 1, as the theory predicts—i.e. a 1 per cent increase in the money stock leads to a depreciation of the currency by 1 per cent. (Note that in all these simulations the foreign money stock is kept unchanged.)

Suppose, now, that a researcher who wants to know the underlying structural relationship between the money stock and the exchange rate, has at his/her disposal a much shorter sample period, say fifty periods. He/she

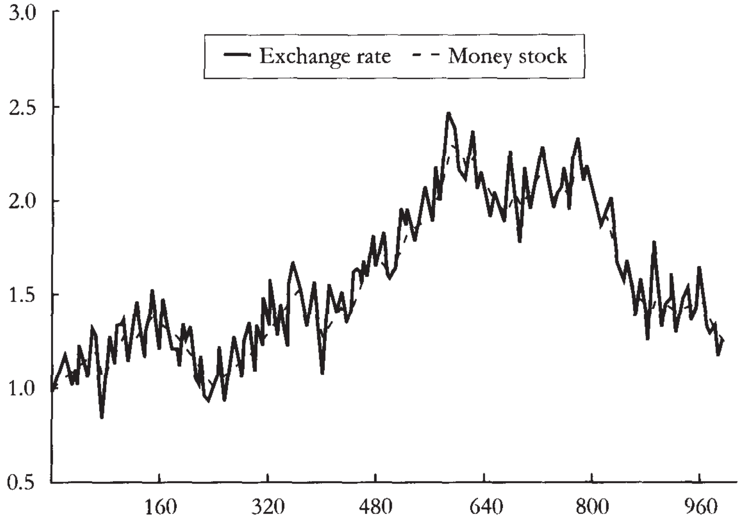

Figure 9.4 Exchange rate and domestic money stock

Source: P.De Grauwe *et al.* (1993), p. 157

then uses regression analysis to detect this relationship. How well will he/she do?

In Table 9.2 we present the results of regressing the simulated exchange rate on the money stock using small sample periods of fifty periods. A first thing to observe is the substantial variablity of the coefficient of the money stock for these different sample periods. This has to do with the fact that the chaotic model produces a lot of endogenous noise. This can also be seen from Figure 9.5, which shows the exchange rate and the money stocks during these small sample periods. One observes that, although in the long run there is a relatively close fit between the exchange rate and the money stock, in the short run this relationship is weak. The variability of the exchange rate is much larger than that of the underlying money stock, and many of the cyclical movements of the exchange rate are not explained by the movements of the money stock.

Note that this feature has also been observed in empirical studies of the relation between money stock and the exchange rate. Over a sufficiently

Table 9.1 Regression of the exchange on the domestic money stock (1,000 observations)

Constant	*Money stock*	*rho*	R^2	*DW*
0.02 (0.5)	0.99 (32.8)	0.9 (70.3)	0.99	1.3

Table 9.2 Regression of the exchange on the money stock (50 observations)

		Sample period: 900–50		
Constant	*Money stock*	*rho*	R^2	*DW*
0.00 (0.0)	0.97 (3.6)	0.83 (12.9)	0.85	0.9
		Sample period: 950–1,000		
Constant	*Money stock*	*rho*	R^2	*DW*
0.46 (1.4)	0.65 (2.7)	0.90 (12.6)	0.9	1.4
		Sample period: 1,000–50		
Constant	*Money stock*	*rho*	R^2	*DW*
−0.12 (−0.4)	1.07 (5.0)	0.91 (15.2)	0.93	1.2

long period of time the correlation between exchange rate and money stocks (and, for that matter, price levels also) tends to be relatively strong. This strong link tends to disappear over shorter periods.

The next step in the analysis consisted in asking the question of how well a forecaster would fare if he/she used the estimated equations of Table 10.2 to forecast the exchange rate out-of-sample. Does the knowledge of the underlying stochastic process of the domestic money stock allow him/ her to make good forecasts? (Note that this was also the question Meese and Rogoff asked in their celebrated empirical study of the exchange rates.)

We analyzed this question by comparing the "out-of-sample" forecasts, using the regression models of Table 9.2, with a simple random walk forecast. The latter forecasts next period's exchange rate to be equal to the current exchange rate. The results are presented in Table 9.3, which shows the root mean squared errors (RMSE) of these forecasts. We observe that the RMSEs of the simple random walk forecasts are much smaller than the forecasts based on the regression models. It should also be noted that the latter assume that the forecaster knows exactly the value of the future exogenous variables. Thus, even if the forecasters know the future value of the money stock the use of a structual model leads to inferior forecasts compared to the random walk model, which does not use that information. Note that we obtain this result despite the fact that there is no exogenous noise in the model. The forecaster uses the correct future values of the domestic money stock, and yet this knowledge does not help him/her to predict how the exchange rate will move.[3]

Our results have the following interpretation. The complex dynamics of

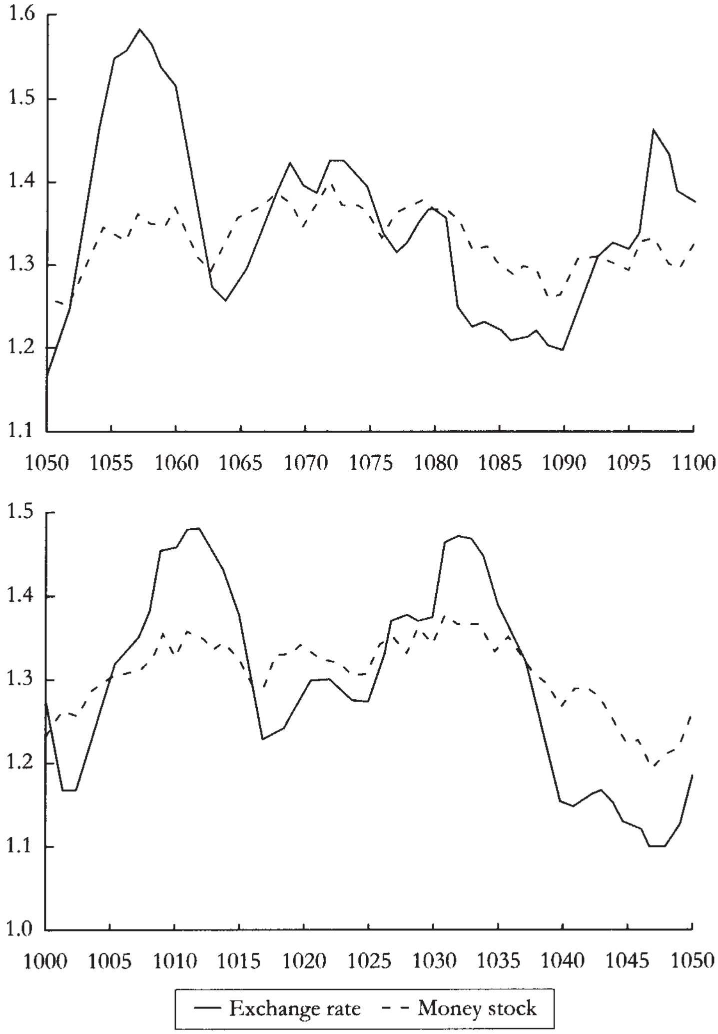

Figure 9.5 Exchange rate and money stock
Source: P.De Grauwe et al. (1993), p. 159

Table 9.3 RMSEs of forecasts with structural models and with random walk (in per cent)

	Structual model	*Random walk*
Period 950–1,000	7.9	4.2
Period 1,000–50	9.2	3.9
Period 1,050–1,100	11.6	4.4

the chaotic model has the effect of obscuring the transmission of the exogenous money shocks to the exchange rate. It is as if the chaotic model works as a scrambling device which erases the short-term influences of money shocks. (As is well-known, this feature is related to the sensitivity to initial conditions.) At the same time, however, the monetary disturbance shifts the position of the strange attractor, so that permanent monetary shocks will affect the level of the exchange rate *on average*. Thus "in the long run" (i.e., if we have enough observations to eliminate the endogenous noise created by the speculative dynamics), permanent shocks in the money stock affect the exchange rate.

This difficulty in the use of structual models to explain and to predict exchange rates has been widely observed in reality. Our model gives an explanation for this result. This explanation is not based on the possibility that the researcher uses the wrong structual model. In our analysis the regressions were based on the correct monetary model. Nor is the explanation to be found in exogenous noise. In our experiments the forecaster uses the correct values of all exogenous variables, and yet this does not help him/her to predict the short-term effects of these exogenous shocks. The factor that obscures the relationship between the money stock and the exchange rate is the speculative dynamics, which introduces a complex (chaotic) behavior of the exchange rate.

CONCLUSION

In this paper it has been shown that relatively simple models are capable of generating exchange rate movements that, at least in the short run, are largely disconnected from their fundamental values. The essential ingredient of such models is the hypothesis that economic agents use different information sets. In this paper it was assumed that there are two classes of agents—fundamentalists and chartists. The former use the information contained in the model and a forecast of future fundamental variables. The latter forecast the future exchange rate based on past exchange rate movements. The interaction of these two classes of agents creates a non-linearity in the model and is responsible for the chaotic behaviour of the exchange rate.

The results of this paper suggest that a speculative dynamics such as the one assumed in our model creates a situation in which the exchange rate appears to have a life of its own. In the short run, the speculative dynamics of chartists and fundamentalists works as a scrambling device, which makes it quite difficult to trace the movements of the exchange rate to shocks in the fundamental variables. Put differently, a movement in the exchange rate due to a shock in the money stock is "embodied" information about monetary disturbances. This information, however, is quickly lost. After a few periods it becomes impossible to trace the exchange rate movements back to the monetary disturbance. The system quickly loses memory. It looks as if exchange rates move without any discernible cause.

Our model, however, also makes clear that the long-run connection between fundamental variables and exchange rates remains powerful. This relationship should be seen as a statistical one—i.e., it predicts how a change in the money stock changes the exchange rate *on average*. The change of the money stocks does not allow us to predict the movement of the exchange rate at one particular moment of time.

The paper does not have the ambition to prove that the foreign exchange market has a chaotic structure. Much more elaborate tests should be performed. Some of these tests have been done, and one must admit that the evidence is mixed.[4] Our intention here was to show that some of the puzzles observed in the foreign exchange market are a natural outcome of a chaotic dynamics.

APPENDIX

In this appendix we describe the model used for the simulations discussed in the main text. For more detail, see De Grauwe *et al.* (1993).

The money market equilibrium condition

Equilibrium in the money market is achieved when the demand for money is equal to the supply. We specify the demand for money in the traditional way. i.e.

$$M_{dt} = Y_t^a . P_t . (1+r_t)^{-c} \tag{1}$$

Where P_t is the domestic price level in period t, r_t is the domestic interest rate. Y_t is the (exogenous) level of domestic output. Note that if we take logarithms of this function we obtain the usual linear specification of the money demand function.

The process determining the supply of money, M_{st}, crucially depends on the policy regime. A policy of strict money supply targetting most often leads to a large short-term volatility of the interest rate, so that most central banks in the world apply some interest rate smoothing procedure in the short run. We therefore assume that the authorities use some interest rate smoothing rule.

Equilibrium in the money market now implies:

$$M_{st} = M_{dt} \tag{2}$$

The open interest parity condition

Assuming that the domestic financial markets are completely open to the rest of the world, the open interest parity condition can be used:

$$E_t(S_{t+1})/S_t = (1+r_t)/(1+r_{ft}) \tag{3}$$

where S_t is the exchange rate in period *t* (the price of the foreign currency in units of the domestic currency), $E_t(St+1)$ is the forecast made in period *t* of the exchange rate in period *t+1*, r_{ft}, is the foreign interest rate.

Goods market equilibrium

Goods market equilibrium is characterized as follows. In the long run, purchasing power parity (PPP) is assumed to hold, i.e.:

$$S^*_t = P^*_t / P_f{}^*_t \tag{4}$$

Where S^*_t is the equilibrium (PPP) exchange rate, $P_f{}^*_t$ the foreign and P^*_t the domestic steady state value for the price level in period *t*.

In the short run, however, one can have deviations from PPP. The shortterm price dynamics is assumed to be determined as follows:

$$P_t/P_{t-1} = (S_t/S^*_t)^k \tag{5}$$

where $k>0$. That is, when the exchange rate exceeds its PPP value, S^*_t, the dometic price level increases. Put differently, when the domestic currency is undervalued this leads to excess demand in the goods market, which tends to increase the price level. The opposite occurs when the exchange rate is below its PPP value (an overvalued domestic currency).

Note that we assume full employment so that adjustment towards equilibrium is realized through price changes. The parameter k measures the speed of adjustment in the goods market. In general, the size of this parameter depends on the choice of the units of time. If the unit of time in the model is say a week, then k will be low compared to a model where the unit of time is a month or a quarter.

One can easily solve this structural model as follows. P_t from equation (5) can be substituted into the money demand equation (1). Together with the money market equilibrium condition, this yields an expression determining the domestic interest rate. The latter is then substituted in the open interest parity condition (3). This yields the following expression for the exchange rate:

$$S_t = Z_t^{\,y}.E_t(S_{t+1})^f \tag{6}$$

where $Z_t = M_{st}.Y_t^{-a}.P_{t-1}^{-x}$ $(x = 1/(1+k))$

$f = 1/(1+k/((1+k)c))$

$y = (1/c)f$

Expectations formation

We assume that there are fundamentalists and chartists.[5] The *fundamentalists* compute the equilibrium (fundamental) exchange rate, which in the present model is the PPP value of the exchange rate. If the fundamentalists observe a market rate above (below) the fundamental rate they expect it to decline (increase) in the future. The rate at which they expect the exchange rate to return to its fundamental value is related to the speed at which the prices in the goods market adjust (the parameter k). It will be assumed that the fundamentalists know this parameter and take that information into account to set their expectations.

The *chartists* extrapolate the past exchange rate movements according to some moving average model.

The change in the expected future exchange rate, therefore, consists of two components, a forecast made by the chartists and a forecast made by the fundamentalists:

$$E_t(S_{t+1})/S_{t-1} = (E_{ct}(S_{t+1})/S_{t-1})^{mt}(E_{ft}(S_{t+1})/S_{t-1})^{1-mt} \tag{7}$$

where $E_t(S_{t+1})$ the market forecast made in period t of the exchange rate in period $t+1$: $E_{ct}(S_{t+1})$ and $E_{ft}(S_t+1)$ are the forecasts made by the chartists and the fundamentalists, respectively; m_t is the weight given to the chartists and $1\text{-}m_t$ is the weight given to the fundamentalists in period t.

The chartists extrapolate recent observed exchange rate changes into the future, using a moving average procedure, i.e.

$$E_{ct}(S_{t+1})/S_{t-1} = ((S_{t-1}/S_{t-2})^{a1}.(S_{t-2}/S_{t-3})^{a2}.(S_{t-3}/S_{t-4})^{a3}\ldots)^{2g} \tag{8}$$

where the coefficients *a1, a2, a3*…are the weights of the moving average, and g is the factor by which the chartists extrapolate the past trends into the future.

The fundamentalists are assumed to calculate the equilibrium exchange rate (the fundamental rate), S^*_t. This is obtained by solving equation (6) forward, given the current and the future values of the exogenous variables. For the sake of simplicity, we set all these exogenous variables equal to one. This implies that the equilibrium exchange rate is equal to 1. Note that PPP holds in equilibrium.

Fundamentalists then expect the market rate to return to that fundamental rate at the speed h during the next period. If they observe a deviation today, i.e.:

$$E_{ft}(S_{t+1})/S_{t-1} = (S^*_{t-1}/S_{t-1})^h \tag{9}$$

It will be assumed that the speed with which fundamentalists expect the exchange rate to return to its fundamental value is equal to the speed of adjustment in the goods market (k).

We now turn to the analysis of how the weight m_t is determined. The analysis is based on the assumption that the fundamentalists have heterogenous expectations. Suppose there are N fundamentalists who make a different estimate of the equilibrium value of the exchange rate at time t. Suppose also that these estimates are normally distributed around the true equilibrium value $S^*t\text{–}1$. We then obtain the picture shown in Figure 9.A1.

When the market exchange rate at time t $(St\text{–}1)$ is equal to the true equilibrium exchange rate (S^*_{t-1}), half of the fundamentalists will find that the market rate is too low, whereas the other half will find that it is too high, compared to their own estimates of the equilibrium rate. If we assume that these fundamentalists have the same degree of risk aversion and the same wealth, the amounts of foreign exchange bought by the first half will be sold by the second half. Thus, when the market exchange rate is equal to the equilibrium (fundamental) exchange rate, the fundamentalists do not influence the market. It is as if they are absent from the market. The market's expectations will then be dominated by the chartists' beliefs.

As the market exchange rate starts to deviate from the true equilibrium

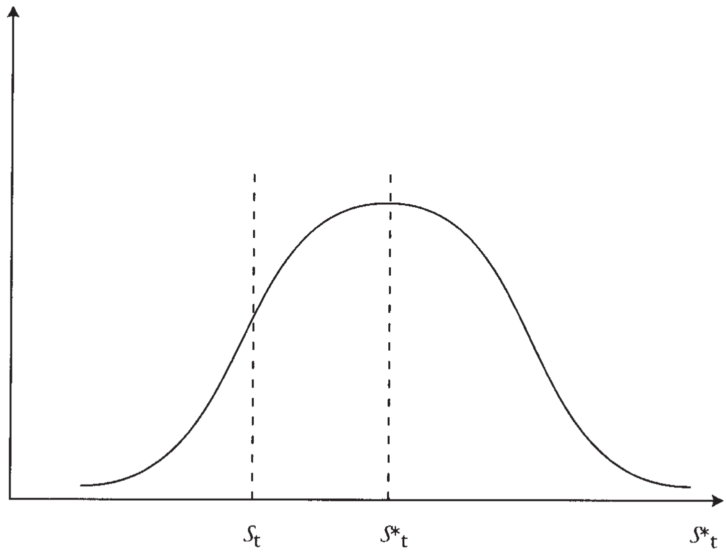

Figure 9.6 Frequency distribution of estimated equilibrium exchange

value, fundamentalists become important again. Take the example of Figure 9.6. When the market rate has declined to S^1_{t-1}, the number of fundamentalists believing that the market rate is too low compared to their own estimates of the equilibrium rate increases, so that their expectations become more important in the market. The weight of the fundamentalists on the market's expectation tends to increase. The same happens when the market exchange rate increases relative to the true equilibrium value.

We conclude that in a world where there is uncertainty about the true fundamental value of the exchange rate, the weight of the fundamentalists' belief in the total market's expectation will increase when the market exchange rate departs from the true equilibrium value.

This leads us to postulate the α-weighting function as follows:

$$m_t = 1/(1+b(S_{t-1}\text{-}S^*_{t-1})^2) \qquad (10)$$

where *mt* is the weight give to the chartists, and $b>0$

Graphically, we can represent this specification as shown in Figure 9.7. From Figure 9.7 it can be seen that when the market exchange rate is equal to the fundamental rate the weight given to the chartists attains its maximum value of one. It is as if there are no fundamentalists in the market. When the market rate deviates from the fundamental rate the weight of the chartists

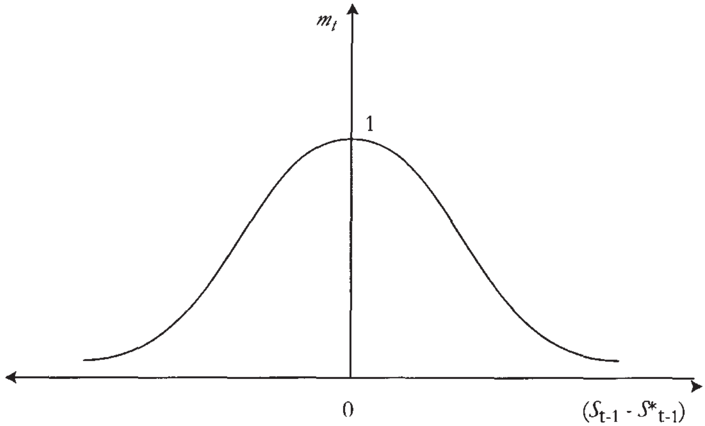

Figure 9.7 The weighting function of chartists

tends to decline. For very large deviations it tends towards zero. The market expectations will then be dominated by the fundamentalists.

Note that the parameter *b* determines the speed with which the weight of the chartists declines. It also measures the degree of divergence of the fundamentalists' estimates of the equilibrium exchange rate. With a high *b* the curve in Figure 9.7 becomes steeper. This means that the estimates of the true equilibrium rate made by fundamentalists are very precise—i.e., there is little divergence in these estimations. As a result, relatively small deviations of the market rate from the true equilibrium rate lead to a strongly increasing influence of the fundamentalists in the market. The opposite is true when *b* is low. In that case, there is a lot of uncertainty in the market concerning the true equilibrium rate. As a result, a movement away from the equilibrium rate induces little reaction from the fundamentalists, so that their weight in the market increases little.

We can now solve the model consisting of equations (6) to (10). Substitute (8), (9) and (10) into (7), and (7) into (6). This yields the following expression for the exchange rate:

$$S_t = Z^{y}{}_{t} 1 S_{t-1}^{f_1 m_t + f_2(1-m_t)} S_{t-2}^{f_3 m_t} S_{t-3}^{f_4 m_t} \qquad (11)$$

with
$$\begin{aligned} y &= (1/c)q \\ q &= 1/(1 + k/(1+k)c) \\ Z_t &= m_{st}\, y^{-a}{}_{t} P_{t-1}{}^{-x} \\ x &= 1/(1+k) \end{aligned}$$

This is the equation used in the simulations discussed in this paper. Given the complexity of this dynamic equation, numerical values are given to the coefficients of the model. These are described in De Grauwe *et al.* (1993).

NOTES

1 See Meese and Rogoff (1983; 1984). See also Baillie and McMahon (1989).
2 See Dornbusch (1976). Bilson (1978). Frankel (1979).
3 This result is similar to the one obtained by Meese and Rogoff (1983) in their analysis of the forecasting performance of structural models.
4 For more evidence see Brock *et al.* (1987), Goodhart and Figlioul (1991), and Guillaume (1993).
5 This assumption has increasingly been used in exchange rate models. See De Long *et al.* (1990), Frankel and Froot (1988). There is also substantial empirical evidence supporting this assumption. See Allen and Taylor (1989).

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