

# International Monetary Reform and the Prospects for Economic Development

John Williamson <sup>1</sup>

This paper discusses what scope exists for reform of the international monetary system to improve the prospects for economic development. It starts by describing what is meant by an international monetary system, emphasising how official arrangements depend on the position of the private sector. The next section assesses the interests of the developing countries in international monetary arrangements. That leads into a discussion of which proposals for reform have been overtaken by events and which look more promising.

## I. THE ELEMENTS OF AN INTERNATIONAL MONETARY SYSTEM

An international monetary system consists of three elements. The first is an *exchange-rate regime*, which determines the rate of exchange at which one money is traded for another. Second, there must be *reserves* that can be transferred in settlement of surpluses or deficits when transactions are unbalanced. Third, an international monetary regime also involves *adjustment obligations*, covering both a specification of when imbalances should be adjusted rather than financed and who is to take what action when adjustment is called for.

Official arrangements concerning those three topics are not determined in a vacuum. What is feasible depends critically upon the state of the private sector. For example, in the early postwar years capital mobility was still low. This was in part a consequence of the fact that most countries still maintained capital controls, but it is very doubtful whether a reimposition of capital controls could take the world back to where it was in the 1950s. The fundamental fact is that not many investors were prepared to consider investing outside their home market, and that fact made capital controls feasible. Thus capital controls and a fear of foreign investment were mutually

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supportive: to resort to the former now that the latter has disappeared would invite massive evasion.

As long as capital mobility was low, and speculative capital movements were effected mainly through leads and lags, it was possible to maintain an “adjustable peg” *exchange-rate system*, in which parities were occasionally altered in sizeable discrete steps. As capital mobility increased through the 1960s, and industrial countries progressively abolished their capital controls during the subsequent two decades, this system became increasingly less manageable. An attempt was made to operate a fixed-rate system in the 1960s, but that attempt ultimately collapsed,<sup>2</sup> and the world learned the hard way that it had outgrown the adjustable peg. After a series of severe speculative crises, the major countries resorted to floating rates. When the European countries once again revived a system of pegged rates (the EMS), they kept individual parity changes small enough to limit the incentive to speculate, almost as though they had agreed to institute a crawling peg.

It is possible for the *reserve assets* used by the official sector to be quite different to the assets utilised by the private sector. For example, in the early postwar years most reserves were held in the form of gold, while in most countries the private sector had been prohibited from holding gold except for artistic and industrial purposes. This historical precedent presumably encouraged the international monetary reformers of the 1960s to invent a reserve asset (the SDR) that would be held only by the official sector. In fact, however, this situation is historically unusual. Until 1914 the gold standard had operated with gold being held both as a monetary asset by the public and as a reserve asset by the official sector. And in the postwar period most central banks ultimately concluded that it was more convenient to build up their reserve holdings in the form of dollars; this was what they acquired in intervention when their country was in surplus, and what they would need to sell to the private sector in order to defend their currency if it came under pressure in the exchange markets. Hence the vehicle currencies found to be most convenient by the private sector tend to become the reserve currencies as well.

The state of the private sector also has a profound impact on official arrangements as regards *adjustment*. Capital mobility permits the financing of large current account imbalances; indeed, as long as confidence is maintained, the limit to a payments deficit provided by a reserve constraint disappears. The reserve constraint is replaced by a *creditworthiness constraint*. This tends

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2 The attempt collapsed for two reasons. First, it proved necessary to change the exchange rates of countries like Britain to facilitate the adjustment process (given that there was still a reluctance to sacrifice full employment to the needs of the balance of payments). Second, it proved necessary to permit countries like Germany and the Netherlands to avoid importing US inflation.

to be a much more elastic constraint, which can at times allow countries to go very heavily into debt. The cost is that at other times the constraint can become much tighter, stranding countries with large volume of unserviceable debt, as happened to many middle-income countries when the debt crisis broke in 1982.

## II. THE INTERESTS OF DEVELOPING COUNTRIES

How are the interests of developing countries affected by the organisation of the international monetary system?

Perhaps the most important interest of developing countries runs parallel to that of industrial countries: to maintain a high and stable level of economic activity in the world economy. Views have, however, changed over the years as to how much it is reasonable to expect any system to deliver. During the heyday of postwar Keynesianism, it was common to assume that policy could maintain full employment, with the high commodity prices and booming export markets that it brings, at the cost of a stable rate of inflation. Nowadays it is generally believed that any unemployment rate below the “natural rate”<sup>3</sup> will lead not to a stable inflation rate but to an accelerating rate of inflation, since unions will demand and firms will grant wage increases that incorporate expectations of future inflation. Expectations are bound to catch up with reality before long as firms raise their output prices to pass on increased labour cost, which fuels expectations of future inflation.

According to this view, the most that one can ask of an international monetary system is that it avoid major accelerations in inflation and larger recessions than are needed to control inflation, i.e. that it help to stabilise output near the highest level consistent with the continued control of inflation. This implies that the benefits that developing countries can expect to reap from the sort of boom conditions witnessed in the early 1970s will necessarily be temporary; indeed, the benefits of any such temporary boom will be more than offset by the losses suffered during the subsequent recession that will be needed to squeeze inflation out of the system.

A number of economists have followed Keynes’ wartime proposals in arguing that countries with a tendency to develop balance of payments deficits – which presumably includes most developing countries – have an interest in a system in which the surplus countries have an obligation to adjust. The original idea is clear enough: in a 2-country world with fixed exchange rates, an obligation on the deficit country to adjust would result in a

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3 This is sometimes called the nonaccelerating inflation rate of unemployment, or NAIRU.

contraction of trade and output, while a transfer of that obligation to the surplus country would replace the contractionary bias by an expansionary one, which would be unambiguously desirable in a world with Keynesian unemployment in both countries. Even if the deficit country had unemployment while the surplus one did not, a transfer of the burden of adjustment to the surplus country would bring a clear benefit to the deficit country. But this clarity vanishes if we accept the argument of the preceding paragraph and recognise that persistent Keynesian unemployment is the exception rather than the rule. The aim of policy becomes to stabilise output near the natural rate, rather than always be seeking to raise it. Moreover, acceptance of the legitimacy of exchange-rate changes as an instrument of the adjustment process reduces the importance of the problem further, since the only “burden” involved in country A devaluing rather than B revaluing is in the former rather than the latter having to announce the change.<sup>4</sup>

However, there is an element of truth in the argument about the desirability of spreading the burden of adjustment. When total world demand is about right and some countries are in payments surplus while others are in deficit, then both groups should be required to contribute to restoring balance, rather than concentrating the obligation entirely on the deficit (or, for that matter, the surplus) countries. Such symmetrical rules will help to dampen the world business cycle.

Perhaps the most famous proposal to use international money arrangements to benefit developing countries was the so-called “link” proposal. This suggested that newly-created international reserves – specifically, SDRs – should be distributed in the first instance to developing countries, who would thus be able to gain a real resource transfer by spending those reserves they obtained in excess of their long-run holding need. (The proposal got its name from the idea that it would link two quite different international objectives, that of providing an increase in the volume of reserves needed to satisfy reserve accumulation objectives and that of securing a transfer of real resources to developing countries in order to accelerate the process of economic development.)

When the link was first proposed, the interest rate on the SDR was very low, and hence receipt of SDR allocations in excess of long-run holding needs would have conferred a clear benefit on the recipient countries. However, in the course of the 1970s the SDR interest rate was raised,

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4 In a multicountry world there is a more substantive issue in who changes their exchange rate, since that also influences the cross rates against third currencies. In fact, this should clearly be the dominant criterion in determining whether A revalues or B devalues; but note that this cannot be altered by enunciating a principle regarding the symmetry or asymmetry of the adjustment process.

essentially to the average market interest rate in the highly creditworthy countries whose currencies were used to value the SDR. This reduced the value of receiving SDR allocations. Indeed, countries as creditworthy as those whose currencies compose the SDR basket no longer received any benefit by receiving SDR allocations. Even less creditworthy countries, such as most developing countries, found the benefit – which consisted of the opportunity of borrowing at the SDR interest rate rather than at the higher rate that they had to pay in the capital market – reduced. Thus the attractiveness of the link declined (though it was not eliminated).

More generally, developing countries clearly have an interest in a system that gives them access to a world capital market from which they can borrow in order to finance a transfer of real resources that will allow them to increase investment. The terms of such borrowing matter, as well as the quantity: clearly long maturities are better than short, low interest rates are better than high, untied loans are better than tied, and debt-service obligations that vary with ability to pay are better than those that are specified exogenously (let alone those that tend to increase when ability to pay declines).

Finally, and presumably most controversially, I at least would argue that developing countries have an important interest in a system with sufficiently well-specified international rules to help them resist self-interested pressures from interest groups and the ruling political elite when these conflict with the interests of society at large. It is by now widely accepted that the international community made a profound mistake when it exempted developing countries from the usual GATT disciplines, since this deprived the governments of developing countries of a powerful argument that they could have used in standing up to the appeals of their protectionist lobbies. Similarly, there is surely a political economy argument in favour of constraining governments, including those of developing countries, from undertaking short-run expansionary policies that compromise a country's long-run prospects, or from building up foreign debt to an extent that threatens to undermine creditworthiness. This argument applies to the United States as much as to any other country.

### **III. PROPOSALS FOR INTERNATIONAL MONETARY REFORM**

A traditional proposal addressed to the first objective discussed above, that of keeping output close to the maximum level consistent with the continued control of inflation, has been to convert the IMF into an embryonic world central bank. This was essentially Triffin's vision of international monetary reform, and it is a vision that inspired European proposals in the Committee of Twenty (C-20) in 1972-74. The basic idea was to add an SDR component

to the existing and essentially fixed stock of gold, so as to create a world reserve base under the control of the IMF; to write a set of rules (notably asset settlement) that would ensure that monetary expansion in all countries was limited by the size of their stock of reserves; and then to use the IMF's control over the reserve stock in order to achieve a steady rate of growth of international reserves, hopefully thus inducing a rate of growth of nominal income consistent with minimising inflation while avoiding recession.

Although I was a strong supporter of this agenda at the time, I have to say that I no longer regard it as realistic. The reason is that capital mobility has gone too far to make it conceivable that asset settlement might be restored. The tendency since the early 1970s has in fact been all in the opposite direction: instead of the United States being unique in its ability to settle its deficits by issuing its own liabilities, all the other industrial countries have acquired a similar ability to finance deficits by borrowing. Admittedly they have to borrow from the private sector, rather than being able to rely on foreign monetary authorities acquiring their obligations, but the effect is the same: that reserves no longer constitute an effective constraint limiting monetary expansion. If one accepts that the development of capital mobility is irreversible, the idea of controlling the world economy by developing the IMF into a world central bank is no longer within the realm of technical feasibility.

A part of the C-20 agenda was to have regular SDR issues in order to secure a steady rate of growth of the world's monetary base. Would regular SDR issues still make sense once one abandons the attempt to make the stock of SDRs a part of a world monetary base? So far as the industrial countries are concerned, the answer is clearly in the negative; these countries are sufficiently creditworthy to be able to borrow what they need for reserve accumulation on essentially the same terms on which they would receive SDRs.

This is not true for most developing countries. Even those that have access to capital markets generally have to pay an interest premium substantially above the SDR rate, and many cannot borrow on any terms. These countries thus have to export real resources, or borrow on more costly terms than the interest they receive, in order to build up their reserves over time. In effect, the poor countries have to provide reverse aid to the rich in order to build up a prudent level of international liquidity. This is surely unjust; and a case for resuming SDR allocations can be made on the basis of remedying this injustice. Unfortunately, however, this seems to be the strongest case that can be made for allocating SDRs, and it is one that has not so far moved the major industrial countries to action. (Things might have been different if the IMF had got into the habit of making regular allocations, but ironically the dispute over the link was probably a factor in preventing that happening. The

arguments against the link were intellectually puerile, but once the depth of the hostility to the proposal in some industrial countries had become evident, a strategic retreat might have been wiser than the rigid insistence dictated by the confrontational North-South politics of the mid-1970s, which effectively killed off the SDR.)

Two other reform proposals from the C-20 era are surely impractical in the age of mobile capital in which we now live. One is to return to the adjustable peg (or “stable but adjustable exchange rates”, the famous oxymoron coined by the C-20 to describe the system of occasional large exchange-rate changes). The choices in future are between the classic alternatives of (truly) fixed rates and floating rates, or else one of the intermediate regimes consistent with the continuous maintenance of asset market equilibrium: managed floating, the crawling peg, or target zones where changes in the central rate are limited to the width of the zone.

The other C-20 proposal that should be abandoned once and for all is the idea of controlling or offsetting flows of speculative capital. The upset in the financial world that would be involved by reimposing effective administrative controls on international capital flows makes this a nonstarter. And the size of the official support funds that would be needed to hold a rate in the teeth of expectations that it was likely to be changed by a large amount in the near future (and in the absence of effective administrative controls) would be prohibitive. Reform proposals need to be consistent with the degree of international capital mobility that is now reality.

If one accepts the objectives and constraints that have been suggested above, what scope exists for reform?

A first area is in regard to *policy coordination*. The absence of such coordination has long seemed to me to be the key inadequacy of the international monetary arrangements that followed the failure of the C-20 to negotiate a reformed system, and hence Marcus Miller and I developed a “blueprint” for policy coordination among the main industrial countries in a study published in 1987. This blueprint,<sup>5</sup> which is sketched in an appendix, envisages an agreed set of target zones for exchange rates and agreed formulae for the expansion of nominal domestic demand among the G-7 countries. As stated earlier in this paper, the potential benefits of effective policy coordination are less dramatic than they were customarily painted in an earlier, more Keynesian, era; but I would still argue that developing countries would stand to benefit from the arrangements that curbed outbursts

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<sup>5</sup> John Williamson and Marcus Miller, “Targets and Indicators: A Blueprint for the International Coordination of Economic Policy”, Institute for International Economics, Washington, 1987.

of global inflation and limited global recessions, as the blueprint proposals are designed to do.

A second, related area of possible reform stems from the remarks in the previous section about the desirability of developing (and industrial!) countries subscribing to *a set of international rules that would limit their freedom to act against their own long-run interests*. The blueprint proposals for policy coordination are aimed inter alia at providing such constraints for the largest industrial countries, as well as ensuring the mutual consistency of their policies (an objective that matters only for the largest countries, which is why it makes sense to present these as two distinct reform proposals). One would want such a set of rules to create a strong presumption against the things that tend to be popular in the short-run at the cost of mortgaging a country's future: excessive levels of indebtedness (both domestic and external), excessive deficits (both fiscal and balance of payments), an uncompetitive exchange rate, and an excessive pressure of demand.

None of these things is easily and unambiguously measurable, which means that any agency responsible for monitoring country performance and publicising its findings would have to rely on projections, estimates, and rules of thumb (such as the Maastricht limits of 60% and 3% for debt/GNP and deficit/GNP respectively). This would presumably result in any international agency which took on this role becoming exposed to domestic political controversy, but this seems inevitable; if there were no risk of its decisions being controversial, there would be no need for an agency to make these judgments in the first place. This political sensitivity of the role raises some question as to whether the obvious international agency for this role, namely the IMF, would be suitable. One may hope that the more sympathetic image the Fund has acquired among developing countries in recent years would suffice to overcome its baggage from the more distant past, since one would surely not want to duplicate the sort of expertise concentrated in the IMF.

Another clear interest of developing countries is safeguarding their access to capital markets. These are at present open to countries that the markets judge to be creditworthy, and they will surely remain so; the problem is to make countries more creditworthy. Here it seems to me that a major international initiative is called for, and that the time is now ripe.

The initiative that I have in mind is the creation of a *legal mechanism for the revision of international debt contracts*. The absence of any such mechanism (often described as a parallel to the Chapter XI proceedings under the US bankruptcy law) was often deplored during the debt crisis, since it meant that there was no third party available to adjudicate between debtors and creditors when the former found the continued observance of the contracts that they had signed to be unacceptably onerous. The deterioration in the global environment that took place in the early 1980s was clearly not foreseen when the debts were incurred,

but the debt contracts contained no provisions regarding the revision of their terms if unfavourable contingencies materialised. In the absence of any legal mechanism, debtors had little alternative but to modify their contracts unilaterally, since creditors can hardly be expected to volunteer to receive less than that to which they are contractually entitled. The resulting conflicts were costly to both creditors and debtors.

Several authors have suggested the desirability of establishing a quasi-legal institution charged with renegotiating debt contracts, i.e. an International Debt Restructuring Agency.<sup>6</sup> This might be linked to the Bretton Woods institutions or it might be independent of them. It might act essentially as a mediation or conciliation agency, having its legal powers confined to those needed to impose on the dissenting creditors revised terms agreed by the debtor and a qualified majority of its creditors. Alternatively, such an Agency might take the form of a tribunal with the power to award debt relief through arbitration even against the wishes of the majority of the creditors.

Such a tribunal would need to have its awards based on agreed criteria as to the circumstances in which a country should be entitled to debt relief. Suitable criteria might include:

- exogenous shocks that had led to a substantial unexpected increase in the burden of debt service
- low and declining per capita income
- the lack of a threat to international financial stability
- a presumption that economic recovery is being impeded by a debt overhang
- poor use made of the proceeds of the loan (reflecting inadequate monitoring by the lenders)
- failure of the lender to make a serious assessment of the probability that the borrower may encounter difficulty in servicing its debts
- doubtful legitimacy of the government that contracted the loan
- refusal of the lenders to extend further loans in support of an internationally agreed adjustment programme.

These criteria are intended to provide an incentive for the lenders to behave responsibly, as well as to identify circumstances in which efficiency considerations would indicate a need for debt relief. The fact that relief would depend upon an international mechanism rather than emerging from

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<sup>6</sup> The term comes from Benjamin J. Cohen, "Developing-Country Debt: A Middle Way", Princeton Essays in International Finance no. 173, 1989. Similar ideas were presented earlier in Jeffrey Sachs, "Managing the LDC Debt Crisis", Brookings Papers on Economic Activity, 1986(2), and John Williamson, "On the Question of Debt Relief", appendix to the "Statement of the Roundtable on Money and Finance", Society for International Development, New York, 1985.

threats and bargaining could be expected to increase the speed and decrease the costs of achieving debt restructuring.

An International Debt Restructuring Agency would base its legitimacy on clauses in future loan contracts specifying that the terms of the contract could be revised by the agency to take account of unforeseen contingencies, and that both creditors and debtors would be bound by its decisions. Any debtor that unilaterally revoked this clause would have to anticipate facing sanctions, a consideration that should reassure creditors that it is safe to engage in lending as long as they take care to stay within the bounds of prudence. (The second criterion reflects a judgment that it is imprudent for commercial lenders to finance low-income countries, which ought to look to official sources for concessional finance.)

It is difficult to imagine that the commercial banks might have agreed to the creation of such an agency, with the right to adjust the terms of existing contracts, while the debt crisis was still in progress. The current lull would seem an opportune moment to raise this issue. Its creation at this time might also help to address the current problem of deterring excessive capital inflows to Latin America, since those making loans under current circumstances might well be judged guilty of imprudence if debt problems emerge subsequently.

The suggestions advanced above do nothing to allow developing countries to acquire the trend increase in their reserve needs without making a reverse transfer of real resources to the developed countries. The obvious instrument to that end remains *a resumption of SDR allocations*. Is it possible to conceive of a formula that might conceivably entice the industrial countries to abandon their opposition to SDR allocations?

Consider the following idea. The IMF would survey how many countries were unable to borrow internationally at an interest rate close to (say within 1 per cent of) the SDR interest rate. If a substantial block of countries (say those with IMF quotas totalling one quarter or one third of the total) were found to be in that situation, the Fund would aim to issue as many SDRs as those countries had revealed they wished to hold. Countries' revealed desires would be measured by the actual past increase in their reserve holdings during the preceding five-years ("basic") period. The IMF would then calculate the scale of SDR allocation that would be needed to supply those countries in aggregate with a similar reserve increase during the forthcoming basic period, and would issue SDRs on that scale.

All participants would receive SDR allocations over the following five years on the scale needed to satisfy the revealed reserve needs of the less creditworthy countries. Since reserve needs tend to grow more rapidly in absolute terms over time, this would in general mean that the less creditworthy countries would not in fact be able to satisfy their entire reserve

accumulation objectives through SDR allocations, but they should be able to satisfy the bulk of them that way. Receiving SDR allocations is a matter of complete indifference to a creditworthy country; however, these countries would suffer collectively to the extent that the less creditworthy countries would no longer have to export real resources<sup>7</sup> to them in order to build up their reserves. The hope would be that allocation on the scale determined by this formula would enable the creditworthy countries to recognise that this loss would simply end existing payments of reverse aid (by the poor to the rich) rather than constitute additional aid.

#### IV. CONCLUDING REMARKS

I have argued in this paper that many of the traditional proposals for international monetary reform have been overtaken by events, notably the growth of a global capital market. Given the basic judgment that this development is not reversible (whether or not one would welcome it being reversed), it follows that there is no point in pursuing proposals for a world central bank,<sup>8</sup> reinstatement of the adjustable peg, or the control of speculative flows.

But the disappearance of this traditional agenda does not mean that there are no worthwhile reforms to pursue. I have sketched the case for the following four reforms:

1. Adoption of the Williamson-Miller “blueprint” for policy coordination.
2. Agreement that an international agency (the IMF?) be charged with the responsibility for monitoring country policies and issuing public warnings about unsustainable policy choices.
3. Introduction of an International Debt Restructuring Agency charged with revising the terms of international debt contracts when exogenous circumstances change in a way that makes it excessively costly for a debtor to fulfill the terms of its initial contract.
4. Resumption of SDR allocations, based on a formula designed to enable the less creditworthy countries to satisfy their long-run reserve accumulation objectives without the reverse aid implicit in current arrangements.

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<sup>7</sup> Or, for those with some creditworthiness, borrow; but (unlike the countries being described as creditworthy) paying a premium over the SDR interest rate.

<sup>8</sup> Of course, that will change if and when the world reaches the point where it is ready to consider the possibility of moving to a single currency. What has vanished is the idea of a two-tier structure in which national central banks are influenced by the attempt to maintain a more or less constant reserve ratio at a world central bank.

# Appendix

## The Williamson-Miller Blueprint for Policy Coordination

The blueprint assumes a conventional specification of the goals of macroeconomic policy. Governments like a high level of activity (implying also a high rate of growth and a high level of employment). They dislike inflation, with an intensity that grows progressively as inflation rises. And they have some objective, at least within a range, for their balance of payments on current account. This is not necessarily a zero balance, but at a minimum it must be a range within which any imbalance will not raise questions about the sustainability of financing. Of course, some governments may have well-defined ideas about the desirable level of lending to, or borrowing from, the rest of the world.

Governments cannot in general have everything they would like. Trade-offs must be faced. In particular, lowering inflation generally requires some temporary slack in the economy. Higher activity tends both to increase inflation and to worsen the current account. A more competitive exchange rate, designed to improve the current account at a given level of activity, tends to increase inflationary pressure.

The blueprint is based on using a medium-term framework to resolve these trade-offs. Each of the participating countries – say the members of the Group of Seven (G-7) – would be expected to have some notion of the natural rate of unemployment (NAIRU). Their choice should be continuously monitored for realism by whatever international secretariat (presumably the IMF) that was charged with responsibility for servicing the policy coordination process. Each country would also select a current account target. Where a government had no precise view on what current account balance was appropriate, one could take the middle of the range that was judged to be sustainable as the provisional target.

The secretariat would then have to appraise the mutual consistency of the various targets, taking account of what appears sustainable and acceptable to the rest of the world. If an inconsistency emerged, it would have to be bargained away; the less governments have precise views on current account targets, the less troublesome this should be. Finally, one would need to check that the chosen NAIRUs were consistent with the current balance targets. (To the extent that a more favourable current balance implies a more competitive exchange rate and thus lower real wages, it would tend to raise the NAIRU if wage-earners have a target real wage.)

Each country would commit itself to a macroeconomic strategy designed to lead to simultaneous “internal balance” – defined as unemployment at the natural rate and minimal inflation – and “external balance” – defined as achieving the target current account balance – in the medium term. Since exchange rates affect trade only with long lags, this implies a commitment to hold the exchange rate close to the level <sup>9</sup> needed to reconcile internal and external balance during the intervening adjustment period. This is the exchange rate that I call the ‘fundamental equilibrium exchange rate’ (FEER), in recognition that it is the exchange rate that implies an absence of ‘fundamental disequilibrium’ in the old Bretton Woods sense <sup>10</sup>. Policy should be directed to keeping exchange rates reasonably close to their FEERs. (Because of doubts as to whether the authorities of the major countries would be wise to give overwhelming priority to exchange rate targeting, the proposal allows for wide bands and, in extremis, soft margins.)

The other intermediate target, in addition to the exchange rate, is growth of nominal domestic demand. The idea of targeting this is a slight variation on the proposal to seek a constant growth rate of nominal income. It has most of the advantages of a nominal income target, in terms both of providing a constraint on inflation (a ‘nominal anchor’) while allowing some elasticity to mitigate a supply shock, and of avoiding the shocks that come from a money supply rule when velocity changes.

Our proposal to endogenise the rule would allow rather more accommodation of an inflationary shock and rather more effort to combat a recession, for two reasons. One is the view that a limited softening of policy is capable of reducing the short-run costs of adverse shocks. The other is that if governments are asked to subscribe to excessively ‘harsh’ rules they are likely to abandon them just at the time when continued confidence demands that their resolve to stick to rules that will re-establish price stability in the medium run needs to be reinforced.

Our other innovation is to require governments to target the growth of domestic demand rather than income: the difference between the two is the change in the current account balance. Our rule calls on a country with an undesirable large current account deficit (surplus) to target a slower (faster) growth of domestic demand than its desired growth of nominal income, so as to promote correction of the trade imbalance.

The final step involves translating the implications of the two intermediate targets into ‘rules’ to guide monetary and fiscal policy. We suggested three such rules, subject to two constraints.

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<sup>9</sup> Or, strictly speaking, the trajectory.

<sup>10</sup> John Williamson, “The Exchange Rate System”, Institute for International Economics, Washington, revised edition 1985.

Rule 1 says that interest rate differentials among countries should be adjusted when necessary in order to reinforce intervention in the exchange markets so as to limit the deviations of exchange rates from their FEERs to target zones. This rule recognises the elementary fact of life that the only effective instrument for managing exchange rates is monetary policy. It does not imply that monetary policy must be devoted exclusively to exchange rate management, because a wide target zone allows substantial scope for monetary policy to be directed to domestic objectives, but it does require that in extreme situations the authorities give priority to the exchange rate.

Rule 2 says that the average world interest rate should be adjusted upwards when the aggregate growth of nominal domestic demand is threatening to exceed its target value (the weighted average of the national targets), or downwards when demand growth is too low. Rule 1 only deals with interest differentials and fails to pin down the average interest rate in the system. It raises the question as to which country should adjust if two currencies reach the limits of the target zone: the one with the weak or the one with the strong currency. The answer offered by Rule 2 is that if aggregate 'world' (in practice G-7) demand is growing too rapidly the weak-currency country should raise its interest rate, while in the converse case of inadequate growth it should be the strong-currency country that should cut its rate. This provides a world rule for aggregate monetary policy to replace the 'dollar standard rule' that the  $n$ th country should seek domestic stability while the other  $n$  minus 1 countries follow Rule 1. It is the key to constructing a symmetrical monetary system of the form that will be appropriate for the multipolar world of the twenty-first century.

Rule 3 says that if the monetary policy called for by Rules 1 and 2 threatens to prevent nominal domestic demand growing at close to the target rate, fiscal policy should be adjusted to compensate. This rule calls for the 'Keynesian' use of fiscal policy to ensure that an exchange-rate-oriented monetary policy does not destabilise domestic demand. Such overt use of fiscal policy became unfashionable in the 1980s, but for no good reason: on the contrary, experiences such as the post-1982 expansion in the United States and the post-1987 expansion in Japan demonstrated that fiscal policy had lost none of its power when the conditions assumed by Keynes (excess capacity and financial confidence) were present.

Constraint 1 says that if fiscal policy is threatening to lead to an unsustainable debt build up, Rule 3 should be overridden if it calls for an expansionary fiscal policy.

According to Constraint 2, if world real interest rates remain abnormally high (say, more than 4 per cent per year) for a sustained period, there should be a concerted global fiscal contraction.

On reflection, I am not sure that the combination of a short-run

anticyclical 'rule' and two constraints motivated by medium-term concerns is necessarily the best way to have specified the conduct of fiscal policy. Perhaps one might instead have started off by asking each country to identify the medium-run fiscal stance compatible with its current-account target, a sustainable debt position, and a 'normal' real interest rate (say 3 per cent). It would then identify a medium-run (say five-year) path for adjusting its fiscal deficit towards the target position. Rule 3 would then be naturally interpreted in terms of deviations from this target path. This reformulation would make it clear that there is a close medium-term link between fiscal policy and the current account deficit.

The blueprint has three objectives. One is to constrain the foreign exchange markets, so as to discourage speculative fads. A second is to constrain governments into acting according to preannounced criteria suggested by the reasonable robust bits of macroeconomic theory and embodying a strong commitment to restoring equilibrium in the medium run, or else justify publicly any deviations that they may feel it expedient to make. The third is to ensure that the policy objectives of the major governments are mutually consistent.