Comment on "International Monetary Reform and the Prospects for Economic Development," by John Williamson

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I read John Williamson's paper with a great deal of interest. There is a lot in his discussion of past experience which I find interesting and which I have not seen elsewhere in quite the same terms. I tend to agree with him that the world had outgrown the adjustable peg system in the early 1970s, although I am surprised not to find among his reasons for this the question of the gold price and only in a very indirect way the fact that from the mid-1960s onwards the United States had failed to provide a stable anchor for the Bretton Woods system. On another point he suggests that parity changes in the EMS had been kept small enough to avoid speculation, which was, however, not foreseen at the beginning. This particular approach actually only represents an intermediate stage after a substantial convergence of inflation rates but before it was discovered that with credibility and, if necessary, with bold short-term interest rate adjustments realignments could be avoided altogether.

But this is not what Williamson whishes us to focus on. He has put forward a revamped agenda for reform of the international monetary system, and presents four reforms which to me seem oddly unconnected. One gains the impression that, in this way, he could also make three or five proposals. It does not strike me as a coherent programme for reform. Perhaps for this reason I feel free to take up his four proposals in reverse order, dealing first with those where I can be rather brief.

Let me start with his suggestion of a resumption of SDR allocations aiming at the less creditworthy countries. I agree with him that there is injustice in poor countries having to provide reverse aid to rich countries in order to build up a prudent level of international reserves. But, I am afraid, there is a lot of injustice in the world and feeling obliged to suggest a special solution in such cases seems to me a bit strange. The burden of having to hold an essential amount of money, whether national or international, always weighs more heavily on the shoulders of the poor than of the rich. By all means let us help them to be less poor, but let us not try to deal with one particular symptom of poverty! By the way, when Williamson says that the arguments against the link have been intellectually puerile, he seems to imply that

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concerns about moral hazard have no intellectual standing. The link would indeed have been a classic case of moral hazard.

Coming to another proposal in Williamson's paper, I fail to see what purpose it could serve to re-create the IMF under a different name. If, as he seems to suggest, the new institution would be expected to be even tougher with national policymakers than the IMF ever had the courage to be, the new institution would quickly be cast in the role of scapegoat just as much as, or more than, the IMF has been. I see a glimmer of hope in this respect, though, as many developing countries now have a better idea of what policies hold out a prospect of success than they had in the past.

Williamson's second proposal concerns the establishment of a legal mechanism for the renegotiation of international debt contracts in the form of an International Debt Restructuring Agency. Would that help developing countries which have problems with creditworthiness or would it harm them? It is of course the recent experience of the debt crisis that puts the idea of special treatment of the foreign debt of developing countries in people's minds. Yet the two lessons to be drawn from this crisis are rather general, and do not suggest the need for new institutional arrangements:

1. Many developing countries did not put borrowed money to good use and pursued irresponsible domestic policies. Creditworthiness depends on the pursuit of the right macroeconomic policies at home – not on new international initiatives;
2. Banks were overeager to lend, but too undemanding in the conditions they imposed. There were many reasons for this, and the banks had paid a high price that has made them more cautious. This is no bad thing: it does not help anybody to grant them loans they cannot service.

Creating a special agency with the power to renegotiate debts seems a typical case of preparing for the last war. It might have been useful had it existed in the mid-1980s. For the future as seen from today it can only create uncertainty in the minds of potential foreign lenders – especially private banks – and make them more reluctant to lend. In other words: developing countries would be hurt, not helped. The criteria that Williamson proposes for possible debt relief would be good reasons for not granting a loan in the first place, so one wonders whether what he has in mind is in fact an International Debt Contracting Agency, empowered to permit – or instruct – banks to lend developing countries.

Presumably not: one could not subject the global capital market to such constraints. During the last couple of years, indeed, capital has been flowing back to the developing world on a substantial scale. Official reserves in the developing world grew by only a little less that $90 billion in 1990 and 1991 taken together (not including the Asian NICs). There is therefore no generalised shortage of reserves in the developing world. A number of

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countries – notably in Latin America – have seen their access to international capital markets improve markedly over the last year or so.

Let me add here a general thought on national creditworthiness. I think it is important that this concept should attract more attention than it has in the past. Most developed countries operate with such a wide safety margin in this regard that they are never forced to consider what it is that national creditworthiness depends on. The term "sovereign risk" in this context conjures up the idea of the state controlling all foreign borrowing decisions. In practice, in many countries that got into trouble such decisions were decentralised. Now the point which is often overlooked is that individual decision-makers cannot take proper account of possible future difficulties in obtaining the foreign currency needed to service their foreign debt. There is actually no effective price mechanism to transmit the external contraints which exist at the macro-level for national economies to the decision-makers at the micro-level. They cannot foresee or prepare for a sudden loss of the country's creditworthiness. Their own project may be highly successful, but such a loss of creditworthiness may still prevent them from servicing their debt.

Avoiding this problem requires the wide safety margin I referred to. This gives macroeconomic policy the time needed to react to any adverse movement threatening national creditworthiness and to cope with large fluctuations in international capital flows. With convertible currencies and exchange rate adjustments, highly developed financial markets provide a large cushion. In small developing countries all this is lacking. Frankly, I simply do not believe they can afford decentralised decision-making on foreign borrowing and foreign investment unless they have gone a long way towards establishing a firm reputation for national creditworthiness. The most difficult cases in this regard are probably those larger developing countries which either have a tradition of free markets or quickly want to get rid of dirigiste bureaucracies but have not had the time to build and earn international creditworthiness with the safety margin that is required to sustain it beyond doubt.

Let me now turn to John Williamson's blueprint for policy coordination. It is in fact not evident what the adoption of his blueprint would do for developing countries, i.e. in the form of a more stable trade environment. Does he expect it to push up the level of demand in the world economy in general? As to the avoidance of misalignments between the major industrial countries, it is pretty clear that these countries are not prepared to commit themselves along the lines Williamson suggests. They can point out that they have managed to keep exchange rates reasonably stable since February 1987 even without such a straitjacket.

But this is not to say that his basic idea is not right. I have been trying to

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make the same point for a number of years. Just as under the system of fixed exchange rates a country's economic policy in the broadest sense is called upon to maintain the convertibility of its currency, under floating economic policy is called upon to maintain a reasonable degree of real exchange rate stability. As exchange rates are a multilateral matter, a reasonable degree of stability of real exchange rates at acceptable levels can only be achieved by coordinated policy action by the countries in question. For the system of floating exchange rates to work satisfactorily, coordination of the policies of key currency countries is to me an essential component. Time does not permit me to consider the question of how best to translate real exchange rate objectives into nominal exchange rate strategies and what role intervention might have to play. Of greater significance is perhaps to what extent the discussion of dirty floating had swayed attention in the wrong direction. There are also nagging doubts as to whether even all these efforts put together can be expected to succeed under all circumstances, given the size of short-term capital flows in globalised financial markets.

Indeed it is this growth of the global capital market that has made many grand schemes for international monetary reform look irrelevant. International capital markets are now deep, flexible and highly inventive (even if they make blunders) and would be capable of financing development worldwide if only domestic reform and policy improvements in the LDCs themselves would provide the preconditions for the latent profitability of investment in LDCs to be realised. While I am not suggesting that there is no need for development aid, it remains true that the more the developing countries can do by themselves for themselves, the better. In this context, Williamson makes an important observation with which I heartily agree: exempting LDCs from the usual GATT discipline did them great harm by depriving their governments of a powerful argument against protectionist lobbies.

Let me briefly sum up. While I am sceptical about his specific proposals, I must say that John Williamson has given us some interesting food for thought, and I share many of his points of view. I believe the issue of national creditworthiness which he addresses is an important one for developing countries, and one that needs to be pursued further.

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