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

Mitsuhiro Fukao

After briefly reviewing the weakness of the present international monetary system, John Williamson proposes the following four reforms: (i) improve the policy coordination process by adopting a fairly detailed code of conduct on monetary and fiscal policy (the so-called "Blueprint" of Williamson and Miller); (ii) create a legal mechanism (e.g. an International Debt Restructuring Agency) for the revision of international debt contract to smooth debt restructuring processes; (iii) adoption of a set of international rules that would limit the freedom of policy that act against their own long-run interest (for example, excessive external borrowings, uncompetitive exchange rates and large budget deficits); and, (iv) a resumption of SDR allocations to compensate perverse real transfers from LDCs to developed countries, generated by increasing reserve holdings of the LDCs.

While I agree with him about the existence of weakness in these areas, I do not think the proposed reforms will rectify these problems.

Enhancing policy coordination and surveillance process

Regarding proposals (i) and (iii), I would like to point out that policy coordination has been tried by the G-7 process and the rule was broadly consistent with Williamson's proposal. In Japan, it was generally felt that the process put too much burden on Japanese monetary policy. The excessive easy monetary policy in the late 1980s to counter the appreciation of the yen has induced an asset-price inflation and the Japanese economy is now trying to cope with its overhang. Moreover, the process has been rather unilateral; the United States did not (or could not) control its fiscal policy and tried to pressure the other G-7 countries to adjust their policies. If the United States would not control its fiscal policy, there is little use in policy coordination.

The IMF has conducted surveillance with its credit as a stick. However, it has not been effective for developed countries that can borrow freely in international financial markets. The OECD has conducted surveillance with a published OECD survey as a stick, but it has not attracted enough press attention in larger countries to be truly effective. One possibility would be to apply the Maastricht criterion on fiscal policy (3 per cent deficit/GDP and 60

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per cent debt/GDP ratio) to non-EC developed countries as a basis of surveillance. The treaty has teeth; the EC can levy fine on offending governments after a warning. However, this level of enforcement of the rule is clearly too ambitious for the G-7 countries.

Thus, it is necessary to find a stronger sanction than the ones already in place but one that is still acceptable to countries participating in the surveillance exercise. One possible sanction against those countries with disruptive policies would be to allow the IMF to declare that they are conducting unsustainable policies. By linking BIS capital weight on national debts to this status, the world community can put stronger pressure on both developing and developed countries. (Under the current BIS rule, national debts of OECD countries and Saudi Arabia carry zero risk weight, while debts of all other countries – unless denominated in respective national currency – carry 100 per cent weight.) I will elaborate on this proposal at the end of my comment.

International Debt Restructuring Agency

With regard to Williamson's second proposal (an introduction of international Chapter XI of US bankruptcy code to LDC debt restructuring), it is necessary to distinguish the difference between companies and countries. A company is controlled by its shareholders and a board of directors, both of whom have clear incentive to be solvent. When a company fails, shareholders lose their investment and directors usually lose their jobs. (Under US Chapter XI procedure, directors of the failed company can retain their jobs, which is an exception in bankruptcy codes of major countries. This lenient treatment in the US bankruptcy code has a perverse incentive to go bankrupt under certain circumstances.) The failed company is usually controlled by an administrator or a receiver of the estate appointed by the bankruptcy court.

On the other hand, the government of a defaulting country does not have a similar incentive structure. The ministers of a defaulting government do not lose their posts and the defaulted country cannot be managed by externally appointed administrators. If an automatic debt restructuring process were in place, there could be a perverse incentive to make use of this debt relief mechanism. If this incentive is perceived by the market, the borrowing conditions for LDCs may deteriorate, increasing the cost of financing for good performing countries.

New allocation of SDR and increasing capital flows to LDCs

John Williamson correctly indicates that LDCs have to generate perverse resource transfers to developed countries when they build up reserves. In

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order to alleviate the cost of reserve building, he advocates a large new allocation of SDR. However, since the allocation of SDR is proportional to the amount of quota, a very large amount of allocation would be required to satisfy the needs of reserve build-ups of LDCs. Moreover, since the allocation would be given to both good performers and bad performers, there is a large risk of moral hazard and excessive borrowing.

Since the primary objective of reserve holdings is to assure the convertibility of the currency, it is more appropriate to use the limited IMF resources to directly enhance the quality of LDC currencies. The LDC debt problem was aggravated by the lost convertibility of LDC currencies. It is necessary to distinguish two kinds of risk faced by creditors: the risk of exchange control and the risk of the project. In the 1980s, when many LDCs could not borrow in the international financial markets, there were still many viable projects in these countries if they were evaluated by their own merit. By maintaining the convertibility of their currency for current transactions and debt services, LDCs could have attracted more private investments and thus alleviated the debt problem. Even if some of the debt has defaulted, they could have been resolved by ordinary bankruptcy procedures.

The IMF can support the maintenance of convertibility of LDC currencies more vigorously. One possible procedure would be as follows; the IMF gives a very generous stand-by compensatory and contingency financing facility (CCFF) in return to a very tight guarantee of the convertibility similar to the establishment of a currency board. By providing a solid guarantee of convertibility, private capital flows would increase. If the IMF observes that a country under this agreement is running an unsustainable policy, it can revoke the CCFF after a warning to the country. With this early warning mechanism, it would be easier to detect and rectify unsustainable policies such as excessive external borrowings or large budget deficits at an earlier stage. If BIS capital rule can be tied to this facility by giving a lower risk weight for those countries with this agreement, bank loans would also be encouraged. The IMF sometimes states that it should not become a rating agency so as to secure confidential information of member countries. However, it already functions as a rating agency because when it starts to negotiate a programme, sooner or later, the international financial community knows it. Moreover, under my proposal, there is a clear incentive for the participating country to stick to the commitment, making voluntary compliance more attractive.

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