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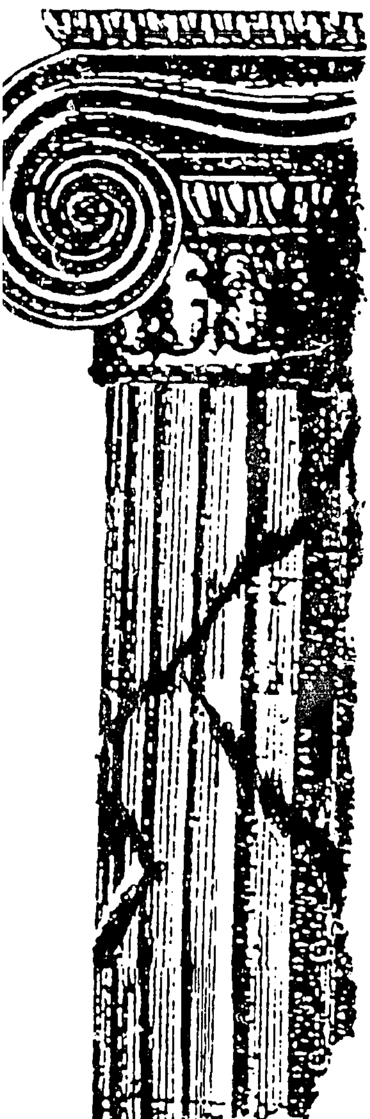

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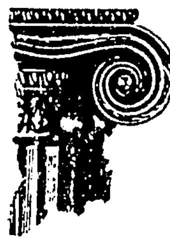

AND DEBT

CHALLENGES FOR THE WORLD ECONOMY

EDITED BY

RUDIGER DORNBUSCH

AND STEVE MARCUS

EXECUTIVE SUMMARY

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—Executive Summary—

International Money and Debt

Challenges for the World Economy

Edited by
Rudiger Dornbusch
and Steve Marcus

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Preface

The world economy was challenged during the 1980s by the burden of debt in the developing countries and by an international monetary system characterized by highly volatile exchange rates. These challenges continue today, as the world community seeks long-term solutions to the problems of the debtor countries and as policy makers work to bring stability to the international financial market.

Since the debt crisis confronted the international consciousness in 1982, it has presented conceptual and practical difficulties for decision making. Not only the governments of the debtor countries, but the industrialized countries, too, have had to come to grips with the crisis. With the announcement of the Brady Plan in March 1989, management of international debt entered a new and hopeful phase; but the crisis is far from over. In the book *International Money and Debt*, current and former chief economists of the World Bank and two former finance ministers of debtor countries explore the policy responses that emerged during the 1980s, as well as the possible future course of international debt management.

The book also addresses problems of the international monetary system. The contributors stress the need for policy coordination and examine the role of central banks in the flexible exchange rate system that prevails today. Political will and commitment will be required to establish true international coordination, in which countries undertake significant modification of their policies in recognition of economic interdependence.

This publication is an executive summary of *International Money and Debt: Challenges for the World Economy*, published in 1991. Most of the essays in that volume were originally prepared for a conference held in Paris on December 2 and 3, 1988, under the auspices of the Israeli International

Institute for Applied Economic Review. We hope they will provide important insights to aid future management of the debt crisis and development of cooperative and stabilizing international monetary policy.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
January 1991

Summary of Conclusions

The debt overhang in the developing countries and instability in the international monetary system present the world's economic policy makers with preoccupying challenges. Since 1989 there has been visible progress in dealing with the debt crisis; but recovery is, at best, just beginning, and the crisis is unlikely to end soon. The international monetary system, since the collapse of the Bretton Woods system of fixed exchange rates, has faced problems of volatility of real exchange rates, exchange rate misalignments, and lack of an adjustment mechanism to act as a check on unilateral economic policies. The adjustment problem reflects the fact that economies are interdependent, whatever the exchange rate regime may be.

In analyzing these two challenges, the authors first address the debt problem.

1. The indebted developing countries include the low-income African countries, whose debt is mostly to official lenders, and a group of highly indebted countries (HICs), many of them in Latin America, whose debt is largely commercial. The debt problems of the HICs were brought to crisis levels in 1982 by excessive borrowing, with resources used to finance deficits; overlending by banks; and sharp deterioration in the world economic environment following the second oil price increase, as commodity prices fell, the dollar became stronger, interest rates rose to record levels, and the demand for manufactured goods declined.

2. Lack of an appropriate international response to the crisis contributed to massive economic deterioration in many of the debtor countries; however, the strategy proposed by Secretary of the Treasury Nicholas Brady in 1989 marked a sharp change

from the status quo in management of the debt crisis. According to the Brady Plan

- Debt reduction was considered essential.
- Resources were to be provided to support market-based debt reduction through buy-backs or interest support.
- Multilateral financial organizations were to begin disbursements for operations to reduce debt and debt service whether or not agreements with banks had been concluded.
- Debtor countries were to contribute to debt reduction by continued economic adjustment and by offering access to foreign investment.

3. Despite initial expectations for the Brady Plan, the most plausible solution for payment of debts continues to be the return of flight capital. These monies would return to the debtor countries if policy makers could trigger the healthy cycle of normality, prosperity, and stability. To accomplish this, debtor countries must take four essential steps.

   - Tax reform. The tax system, especially tax administration, should be reformed to assure more substantial and efficient revenue collection.
   - Privatization. Simply closing many of the extremely inefficient operations in the public sector would benefit the budget; selling them would provide the resources for and confidence in financial stability.
   - Economic development. To reverse capital flight and make payment of the large external debt possible, debt service must now take a back seat to building financial stability. In many debtor countries creditors can be engaged directly in the reconstruction effort, through interest recycling. Resumption of growth in the debtor countries and restoration of voluntary debt servicing and capital flows depends also on multilateral growth in the world economy.
   - Improvement of education and technology. Ending their dismal neglect of education and technology can help

debtor countries compete in world trade without turning to the weapon of last resort, low wages.

4. The Brady Plan addressed commercial debt. Progress has also been made in dealing with official debts.

   - Thirteen African countries have rescheduled debt under the new set of terms agreed on at the 1988 Toronto economic summit.

   - The principle of concessional rescheduling of official claims in severely indebted countries with sound adjustment programs has been established.

   - Debt forgiveness for poor, mainly African, countries immediately reduces the debt of those countries and contributes marginally to a slowing of the debt buildup.

Turning to problems of the international monetary system, the authors find no easy answers but identify several important principles.

5. International coordination of economic policy may one day provide better management of the interdependent financial system, in which volatility of exchange rates has been the rule since 1973. After a long period of floating rates and currency misalignment, however, it will not be easy to establish the basic conditions for a viable system of stable exchange rates.

6. In the highly interdependent and integrated world financial system, in which flexible exchange rates, misalignment, and halfhearted coordination prevail, central banks of major countries have emerged as vocal and powerful participants in international economic management. Their cooperation is vital to the establishment of any structured coordination of international monetary policy.

7. There is no perfect solution to the problem of reconciling coordination with the existence of independent nation states. Any international arrangement will be incomplete and will be more political than technical. But the international economy needs some kind of anchor.

8. Rules make the anchor visible and real. A voluntary framework of economic self-discipline, currency competition in the emerging multicurrency global system, and coordination of economic policy, supplemented by rules agreed upon by central banks, can provide the basis for stability in the world economy.

An Overview of
International Money and Debt

For more than a year before the announcement of the Brady Plan, the overall external debt of the developing countries had been kept relatively constant by a low level of net flows; by dollar appreciation, which reduced the dollar value of nondollar debt; by a small amount of debt reduction through buybacks, swaps, and forgiveness; and by forgiveness of concessional official development assistance (ODA) loans. Slow growth of debt could be an encouraging sign of progress; but investment remained depressed in both the HICs and the indebted countries of sub-Saharan Africa, and the leveling off of debt led to little or no improvement in the standard debt indicators.

Recent Debt Developments

Within six months after the Brady Plan was launched, the World Bank and the International Monetary Fund established operational guidelines to support reduction of debt and debt service, and Japan earmarked funds for parallel support. More than $30 billion became available for debt-reduction operations. Agreements for debt relief under the plan were reached with Mexico and the Philippines.

In his chapter on the debt problem, in *International Money and Debt*, Stanley Fischer writes that early results of the Mexican agreement have been encouraging. Investors' assumption that the agreement will give Mexico stability for four or five years led to the return of flight capital and to an immediate decline of twenty percentage points in the real interest rate. This rate decline completely changes the growth prospects for Mexico. For other

HICs, debt reduction along Brady lines could reach 20 percent of the total debt of beneficiary countries, reducing their interest burden by as much as \$8 billion. If investors gained substantial confidence in the stability of the medium-term financial outlook, there could be even more dramatic impact on growth.

The involvement of the World Bank in agreements for debt relief raises the question of whether it is proper for a development agency to participate in such financial transactions. The answer, says Fischer, is clearly yes, since attempting to reduce the impact of overindebtedness on growth is fully consistent with the Bank's basic developmental objectives. It may also be asked whether the international financial institutions are taking on risks that the commercial banks should bear. Fischer concludes that a limited increase in the Bank's share of the debt is justifiable, if it accompanies a reduction in the debtors' overall debt burden.

In addition to the progress made on commercial debt under the Brady Plan, there have also been advances in dealing with official debts. By mid-1989, thirteen sub-Saharan African (SSA) countries had benefited from a rescheduling agreement reached at the 1988 Toronto economic summit. For poor, mainly African, countries, the forgiveness of ODA debts has been extended. The United States, France, Germany, and Canada have begun to cancel SSA debt amounting to \$3.3 billion, DM2.6 billion, and C\$500 million.

Twenty-two countries are now drawing on the World Bank's Special Program of Assistance (SPA). Moreover, bilateral donors have provided an additional \$6.2 billion of concessional funds, as well as concessional reschedulings and debt forgiveness. SPA countries are also eligible for other concessional programs of the International Monetary Fund. There are plans, under a new program of the World Bank, to make \$100 million available to support repurchase of commercial debt in low-income countries. Although commercial bank debt is relatively small in most of these countries, it often represents a high share of debt service and can impede access to trade credit. Through concessional programs, many low-income African countries have achieved a level of net resource flows consistent with a resumption of growth.

Some indebtedness falls outside the scope of the existing tools. The income levels or geographic location of some countries with mainly official debt keep them out of the SPA and ineligible for rescheduling. (Among these countries are Bolivia, Costa Rica, Dominican Republic, and Honduras in Latin America and Cameroon, Congo, Egypt, and Morocco in Africa.) A few countries (including Sudan, Zambia, and Liberia) have very large arrears to official multilateral creditors and are discouraged from realistic adjustment efforts by the bleak prospect that even if they did adopt realistic adjustment programs, the IMF and the World Bank would not be able to extend the necessary external support. Some way of addressing the debt problems of these countries remains to be devised.

The Outset of the Debt Crisis

Writing about analytical and conceptual issues of decision making at the outset of the debt crisis, Anne O. Krueger shows that the conventional wisdom on borrowing by developing countries seemed to be confirmed in the 1970s.

In the mid-1970s, the commercial banks, with excess liquidity from deposits by the oil-exporting countries, increased lending to developing countries; but several factors, including worldwide inflation's erosion in the real value of debt, kept the rise in debt-servicing ratios small.

By the end of the decade, aggregate debt indicators did not strongly indicate any imminent difficulty. Not only did the conventional wisdom that capital flows benefit both rich and poor countries appear to be verified, but many observers attributed the growth in flows of private capital to the speed with which developing countries were becoming integrated into the world economy.

There were, however, some debt crises in the 1970s and earlier. In the 1950s and 1960s the International Monetary Fund dealt with balance of payments crises that were also debt-servicing crises. By the 1970s, many developing countries had experienced payments difficulties, followed by IMF policy-reform programs that often included debt rescheduling. Some developing countries failed to adjust after the oil price increase and then had difficulty servicing their debt.

The second oil price increase contributed to the onset of the debt crisis of the 1980s. The worldwide recession that followed the 1979–80 increase was accompanied by a sharp and lasting drop in real commodity prices; and the tight monetary policies of the industrial countries resulted in very high nominal rates of interest, which translated into an increase of about 24 percent in the real rate of interest paid by developing countries reliant on private creditors.

In 1981 and 1982, commercial banks continued lending to developing countries, recycling oil revenues much as they had done in 1973 and 1974; but this lending was at variable interest rates, so that as outstanding debt was replaced by new borrowing, the portion of total debt at variable interest rates increased dramatically. Debt-servicing obligations rose because of increased debt outstanding, an increased interest rate, and a higher fraction of debt serviced at that higher rate. In 1981, thirteen countries engaged in multilateral debt renegotiations.

Recognition that things were not normal emerged abruptly in August 1982, when the Mexican government announced that it could not continue voluntarily servicing its debt. Until that time Mexico, as an oil exporter, had been regarded as among the most creditworthy countries in the world. As the Mexican government, the U.S. government, and the IMF grappled with the Mexican problem, the commercial banks reassessed their lending strategies. A number of developing countries suddenly found themselves without identifiable sources of finance to meet their large current account deficits, or to continue servicing their debts. What was a Mexican problem in August 1982, therefore, was by mid-1983 a problem of most of the developing countries that had been borrowing from commercial banks.

The most innovative part of the response to Mexico's plight was the initiation of forced commercial reschedulings of private debt. The IMF and the World Bank were prepared to lend a significant portion of the total amount needed in support of the Mexican program, but they refused to do so until the large commercial bank creditors had agreed to reschedule and had negotiated terms for the rollover and for new money with the Mexican authorities.

Once the Mexican solution was worked out, the IMF took leadership in developing policy packages on a case-by-case basis. Proposals for global solutions based on the premises that the debts were so large as to be unpayable and that they were almost entirely the result of the worldwide recession found little support. Some developing countries (such as those of South Asia) had avoided heavy indebtedness, and others (such as the East Asian exporters and Colombia) had undertaken unpopular policy measures to remain creditworthy and meet debt-servicing obligations. Finally, there were some governments whose policies were so unrealistic that support did not seem warranted.

Several issues in international decision making have arisen from events at the outset of the debt crisis.

- The relationship between Bank and Fund programs is inadequately understood. It would be desirable to have in place an agreement delineating each institution's role, should there arise another international financial problem of the magnitude of the debt crisis.

- Once it is accepted that significant policy reform is a prerequisite to resumed growth, the international institutions need strong support when they decide not to lend to governments that have unsustainable policies.

- What is needed for rescheduling debt to private banks is a procedure in which authorities in the borrowing country can be assured of rollovers, without the need to renegotiate annually with large numbers of creditors, as long as they continue a reasonable adjustment policy.

- Within the governments of industrial countries there needs to be more recognition of the strong link between an open, multilateral international trading system and the developing economies' ability to grow and to resolve debt-servicing difficulties.

- The governments should also recognize the need for adequate funding of the international institutions. There is a question whether the level of resources committed to financing development are great enough, especially if the commercial banks do not reenter the international capital market as a source of finance.

Krueger concludes that the debt crisis was much less a true crisis and much more a long-term problem than was initially supposed. Although the international response, especially by the IMF, addressed the immediate need, it did not provide a permanent solution because the debt problem was less a short-term consequence of recession than a problem of domestic economic policies that were unsustainable in the long run in the environment of the 1980s.

At the outset of the debt crisis, Jesús Silva-Herzog, then finance minister of Mexico, had the task of announcing his country's inability to continue normal payments on its public external debt to the international banking community.

In the fourth chapter of the book, Silva-Herzog sets forth the events that led to the crisis and provides a memoir of internal policy making at that time.

The crisis struck Mexico after nearly four decades of economic growth and internal and external monetary stability. An oil boom in the late 1970s had initiated a period of easy external borrowing and unprecedented growth in Mexico, but the unfortunate consequence of the borrowing was that it allowed the government to avoid dealing with a growing disequilibrium in the domestic economy and in its external economic relations. When oil prices declined, the Mexican economy saw the beginning of an important capital flight, which was countered by more foreign borrowing—about $23 billion in 1981.

In February 1982, the government devalued the peso but did not initiate other adjustment measures; and it became more and more difficult to obtain new loans from foreign banks and renew old ones. By April, Mexico was experiencing heavy capital flight, external disequilibrium, a growing government deficit, and other signs of impending crisis.

Silva-Herzog recalls that inside the government a sense of shock prevailed, as well as reluctance to accept that the boom Mexico had enjoyed for four years had come to an end. A new adjustment program was announced at the end of April, but there was an absence of political will to carry it out. There was also political reluctance to initiate talks with the IMF.

Because they knew that it was only a matter of time until the crisis would explode, a group of Mexican economic and financial officials quietly began to talk with the managing director of the IMF, the U.S. secretary of the Treasury, the chairman of the Board of Governors of the Federal Reserve System, and presidents of private banks, establishing a dialogue that fostered better understanding of the Mexican problems and made later negotiations easier.

During the summer of 1982, exchange instability grew, and foreign borrowing became increasingly difficult. Mexico was then losing foreign reserves at a rate of more than $200 million a day, but the government still believed that it had to honor its debt-service commitments. In August, when further devaluation of the peso failed to stop exchange speculation, restrictions were placed on the convertibility of bank deposits denominated in foreign currency, a dual system of exchange rates was established, and the exchange market was temporarily closed.

By mid-August, when it seemed that all options may have been exhausted and that the only possible action was a unilateral moratorium, Silva-Herzog and Mexican financial officials met urgently with U.S. officials, including representatives of the Treasury Department, the State Department, and the Federal Reserve, in what has become known as the Mexican Weekend.

The participants agreed on an emergency financial package, a key part of which was a $1 billion "oil facility," essentially prepayment by the United States for purchases of Mexican oil. When the United States insisted on what the Mexican team saw as an excessive commission to open the oil facility, the talks broke down. The Mexican negotiators saw the commission requirements as usury and the United States attitude as lacking the cooperative spirit appropriate between neighboring countries; they prepared to return to their country, there to declare a moratorium on payment of the external debt. At that point, Silva-Herzog recounts, the United States modified its position, the two teams resumed negotiations, and a memorandum of understanding was signed.

Facing payments that exceeded remaining international reserves, Mexico next negotiated a ninety-day rollover of amortization payments with the international banking community. The Mexican officials, in their meeting with representatives of the banks, adopted an approach that avoided use of the word *moratorium* and committed their government to remain current in interest payments and adopt domestic adjustment measures. Press announcement of this meeting marked the official start of the debt crisis.

Looking back, Silva-Herzog concludes that rejecting a moratorium was the right decision, one that took into account the growing economic interdependence among nations.

The Colombian Debt Problem

Among the large Latin American debtor nations, Colombia alone weathered the debt crisis without having to restructure its external obligations. Colombia's debt was made up of an unusually large proportion of public obligations with the multilateral institutions rather than the more common overindebtedness of the private sector with commercial banks. This characteristic of its debt, together with a very successful adjustment program, led the country to a financing strategy oriented to regaining access to voluntary lending from commercial banks and to obtaining additional resources from the World Bank. Colombia was able to relegate the IMF's role to the simple monitoring of its adjustment program.

As finance minister of Colombia, Roberto Junguito was responsible for the government's economic strategy during the early phase of the debt crisis. Writing about this experience, he shows that a secret to successful adjustment is appropriate sequencing of the adjustment measures. Colombia found that strong fiscal reform and monetary discipline followed by accelerated crawling peg devaluation could realign the real effective exchange rate without a menacing inflation.

Junguito recalls that at the time of the Mexican announcement, the Colombian government was preoccupied with domestic politics and was relatively unaware of the crisis. When it was faced with a deteriorating economy in 1984, however, Colombia adopted an austere and restrictive adjustment program, characterized by increased taxes, reduced expenditures, postponement of capital-intensive investments, and increased public utility tariffs. When a mounting deficit in the current account and an accelerated drop in foreign reserves signaled the need for an external adjustment, Colombia successfully carried out a nominal devaluation of 51.2 percent within a year. The country was able to reduce imports significantly in 1984 and 1985, without a setback in growth or output. The behavior of the coffee sector was an important element in the success of Colombian trade policy during the early phase of the debt crisis, as the international price of coffee remained stable. By demonstrating that effective adjustment measures were in place, Colombia was able to achieve a series of externally financed jumbo loans without restructuring the public debt.

Beyond the Debt Crisis

What comes next? That commercial banks are withdrawing from the HICs is an inevitable result of their having been overextended in those countries. One alternative source of finance is official development assistance, but ODA is not likely to fill a major part of the funding needs of developing countries, beyond those of the poorest.

Foreign direct investment allows risk to be shared between the host country and the source and brings with it foreign technology and management skills. The World Bank Group's Multilateral Investment Guarantee Agency (MIGA) is beginning to issue its first guarantees and can help to increase the flow of foreign direct investment.

Creditors and developing country borrowers should consider new forms of financing that take advantage of risk-sharing matches between creditors and debtors. For example, commodity-price-indexed bonds may provide useful long-term opportunities and reduce the risks of debt default and renegotiation.

As financial stability and growth prospects in the debtor countries improve, flight capital will return.

Debtor countries remain vulnerable to external shocks, notably protectionism in export markets, higher real interest rates, and world recession; but the international community is making progress in dealing with the debt crisis.

The Changing Role of Central Banks

In discussing international coordination of economic policy, Alexander K. Swoboda argues that central banks have recently been called on to play such an important role in coordination because they control the only instrument of macroeconomic policy that retains flexibility and because the role of exchange rates and monetary policy in current account adjustment is often misunderstood. Monetary policy is then cast in the wrong role, and coordination of fiscal policies—the crucial element of international economic cooperation today—is slighted.

In many ways, the 1960s were the heyday of international cooperation among central banks. Cooperation focused on maintaining fixed exchange rates as an paramount goal of policy and on managing the process of creating international liquidity. In contrast, recent proposals and examples of policy coordination have focused on different goals: stabilizing world potential output, minimizing spillovers from national macroeconomic policies, and achieving a sustainable pattern of current account balances. In several recently proposed schemes, the exchange rate is considered an instrument, rather than a target, of policy.

Swoboda proposes an analytical framework by which he examines the effects of monetary and fiscal policy on the current account under flexible exchange rates. He concludes that long-run considerations leave little room for cooperation by central banks in solving current international imbalances. Instead, he focuses on fiscal policy and the saving-investment balance. He sees a role for cooperation by central banks and for coordination of monetary policy, but he asserts that coordination must be based either on short-run considerations or on traditional considerations involving reform of the international monetary system and must be independent of current account targeting.

Swoboda argues that in the short run and under flexible exchange rates, there is only a limited role for monetary policy cooperation. He points out that one function of a flexible rate regime is to reconcile diverging monetary policies or to free monetary policy for use in achieving internal balance—although there must be some broad agreement on which countries should engage in expansionary or contractionary monetary policies. One thing that monetary cooperation should not try to do, according to Swoboda, is set *real* exchange rates. Stabilization of nominal exchange rates may, however, be pursued (for reasons other than current account targeting). Although ideally this can be done whether or not there is coordination of fiscal policy, in reality and in the short run, such a separation is not possible.

Swoboda observes that a government probably should not try to fix the nominal exchange rate when wide fluctuations in real exchange rates are expected. The problem today is that uncertainty, in particular about fiscal policy, is so high that nobody knows with any precision where real exchange rates will have to go in the near future and by how much they may have to change. Lack of fiscal discipline is thus a major obstacle to stabilizing exchange rates.

The following steps are suggested for international policy coordination and monetary cooperation.

- Address fiscal imbalances.

- While progress is being made on the fiscal front, confine exchange rate stabilization and monetary cooperation to smoothing operations and to massive interventions to correct gross misalignments.

- Once fiscal imbalances have been substantially redressed, begin to implement exchange rate reform.

Economic Policy and Exchange Rates

After the breakdown of the dollar-based Bretton Woods system, exchange rates became increasingly more volatile and tended to overshoot reasonable medium-term equilibrium ranges. The new environment proved generally infertile for economic and monetary cooperation, although there was ad hoc cooperation between the major players when their interests compelled it.

In Europe, the currency "snake" (the deutsche mark, leading other currencies through a "tunnel" of rate fluctuation) offered an early alternative to floating currencies for countries that were willing to tie their fiscal and monetary policies to those of the Federal Republic of Germany. This system showed that exchange rates could be held at desirable levels between countries that shared similar policy concepts and objectives. The European Monetary System (EMS) reintegrated major European partners into a more comprehensive regional system of fixed but adjustable central rates.

At the global level, effective economic and monetary cooperation resurfaced in the mid-1980s. As exchange rates for the dollar increasingly overshot reasonable ranges, apprehension about an uncontrolled market correction led to cooperative efforts among the G5 (France, Japan, the United Kingdom, the United States, and West Germany) and G7 (the G5 plus Canada and Italy). In his discussion of policy and exchange rates, Wolfgang Rieke observes that these countries have remained involved largely because they fear market reaction to signs of failing cooperation.

Renewed cooperation and closer policy coordination by the United States was welcomed by its major industrial partners. The main focus of cooperation was the exchange rate of the dollar in relation to other major currencies. The efforts set in train by the G5 in a meeting at the Plaza Hotel in New York on September 22, 1985—after the dollar had passed its peak and was already down against the deutsche mark and the yen—sought to bring about a controlled further depreciation of the dollar and at the same time to contain the perceived risks of too rapid and potentially harmful correction.

As dollar rates moved down, cooperation efforts shifted to stabilizing exchange rates. The Louvre Accord of February 22, 1987, committed the G7 to fostering stability. Pursuing a multiple objective of stabilization, progressive adjustment of payments imbalances, and noninflationary growth was, Rieke points out, extraordinarily ambitious and faced political obstacles in the United States, Germany, and Japan.

In Germany, concern for the potentially disruptive effects of exchange rate movements on the economy and on Germany's functioning in the EMS favors efforts aimed at stabilizing exchange rates. At the same time, desire for price stability and for effective control over monetary conditions tends to dampen enthusiasm for such efforts. In the United States, concerns about a weakened dollar also relate critically to the risks of accelerating inflation. At the same time, it has been recognized that a marked strengthening of the dollar, against the existing inflation differential between the United States and other major countries, also entails certain risks, with effects on the financial markets that are difficult to foresee.

Concerted efforts among the G7 to influence market sentiment may be reasonably successful when external adjustment is under way but may become less effective when trade figures point to adjustment problems and may be especially unsuccessful if macroeconomic policy stances in major countries suggest that imbalances will continue.

After reviewing the effects of investment, forced adjustment of exchange rates, and capital flows on the trade and current account balances of deficit countries like the United States and surplus countries such as Germany, Rieke concludes that an unfailing commitment to monetary stability is basic to the long-term functioning of the EMS and may eventually eliminate the need for exchange rate adjustment as a means of protecting surplus countries against the importing of inflationary impulses.

Rieke then considers the merits and limitations of economic policy coordination, finding it to represent an advanced stage of international cooperation. The case against policy coordination rests on a variety of concerns that arise from unwillingness to modify national policy significantly. This case is weakened by the fact that the success of the EMS in stabilizing rates between participating currencies has been greater than initially expected. A combination of self-discipline (based on widely shared objectives and concerns), good example (set by the key currency country and accepted by its partners), and cooperation (regardless of differences in economic power) appear to explain the relative success of the EMS.

It is Rieke's view that at the global level the emphasis on self-discipline especially applies to the United States, since exposure to market discipline cannot be relied on to force the United States to correct conditions leading to serious external imbalances. Eminent U.S. observers, however, recognize that sound national economic policy cannot forgo self-discipline based on simple truisms: Money must be scarce; public debt should be strictly limited; current account deficits and reliance on foreign borrowing need to be held in check; market mechanisms should have precedence over state regulation, and protectionism should be avoided.

Rieke concedes that it is inherently difficult to observe these principles; but adherence to them by the major countries, with the United States taking the lead, would reduce the burden on official economic policy coordination, would allow the world economy to return to a system firmly anchored to a key currency, and would give the system a measure of symmetry.

In a multicurrency global system, key currency responsibility would not fall so heavily on the United States as it did under Bretton Woods rules. Such a system would presumably be affected by currency competition involving the yen, the deutsche mark (or ECU), and the dollar; but it could not rely wholly on currency competition to enforce the disciplines required for stability. The voluntary basis of self-discipline, currency competition, and policy coordination will have to be supplemented, according to Rieke, by rules of the kind agreed to by central banks in the EMS.

Market expectations cannot be expected to stabilize overnight. The coexistence of major international currencies and the existence of large payments imbalances add to the difficulty of reining in global market expectations. Imbalances will not easily be corrected, Rieke warns, unless the major deficit country, the United States, practices self-discipline, especially in its fiscal policy.

International Coordination of Economic Policy

In a chapter on international cooperation and central banks, Pierre Jacquet and Thierry de Montbrial analyze the increasing importance of monetary policy in major industrial countries and critically review examples of international economic cooperation between World Wars I and II, during and after the Bretton Woods era, within the EMS, and through the strategy of the Plaza and Louvre agreements.

The authors observe that central banking generally acquires enhanced visibility and function in times of financial and monetary strain, as in the interwar period, when cooperation among central banks was shaped by the numerous financial rescues that had to be implemented. Central banks were prominent in the 1960s, when defense of Bretton Woods parities became a concern; and from 1971 to 1973 the collapse of the convertibility of the dollar and of the system of fixed exchange rates brought the banks again into sharp focus. Floating restored a significant margin of maneuver for central banks, increased the scope of their actions, politicized their role, and helped the development of an independent central bank posture to fill the vacuum left when exchange rate rules disappeared.

Financial and monetary strains in the 1980s enlarged the corrective responsibility of central banks and increased their relative power within the national bureaucracies. The first of these strains was the increased short-term volatility of exchange rates and the emergence of serious misalignments, which revived the concept of managing exchange rates. The lack of adjustment in fiscal policies left to central banks the task of stabilizing exchange rates. The second strain on the world economy was the debt crisis. The Bank for International Settlements in 1983 organized the cooperation of central banks to alleviate temporarily the financial plights of central banks in indebted countries. The third strain was the 1987 stock market crash, which led central banks to feed the markets with adequate liquidity and to state that they were cooperatively committed to that end. Finally, the large increases in bank failures in the United States called for active management under jurisdiction of the Federal Reserve.

In presenting a typology of international economic cooperation, Jacquet and de Montbrial distinguish between cooperation under emergency conditions and cooperation under normal conditions. The first is crisis management, whereas the second aims at preventing undue fluctuations in economic variables such as exchange rates, interest rates, prices, growth, and balances of payments on current account.

Emergency cooperation took place after the Great Depression, in reconstruction after World War II, after the collapse of the Bretton Woods agreement, in the debt crisis, and after the 1987 stock market crash. Attempts to restore the gold standard in the 1920s and the G7 coordination process may also be considered emergency cooperation.

A systemic approach to cooperation in normal times stresses structural interdependence as a constraint on policy makers in framing their policies. The framework, or system, comprises a set of institutions, rules, and practices for constituting policy. The question addressed by systemic cooperation is how to provide international public goods, as opposed to welfare maximization. In international economic relations, such goods include a liberal trade environment and stable exchange rates. Orderly management of the exchange rate system is necessary to avoid the costs of competitive appreciation or depreciation and the potentially disruptive effect of floating rates on international trade relations.

Jacquet and de Montbrial draw from the Bretton Woods experiment several lessons on systemic cooperation. The first is that large-scale intervention to avoid realignments can undermine domestic monetary policies. The second is that a crucial requirement for a stable exchange rate system is the ability to change the official parities smoothly. A third lesson is that the exchange rate system has to accommodate changes in the underlying structure of relative economic power. A fourth lesson is that even though a pattern of hegemonic leadership (exerted by the United States) no longer exists, adjustment obligations have to be symmetrical for deficit and surplus countries.

The authors also draw lessons from the European Monetary System as a good example of systemic cooperation. Within the EMS substantial convergence of economic policies has taken place, although it is clear that further monetary cooperation requires political cooperation and integration and will entail further loss of autonomy in monetary policy. The EMS experience highlights two main areas where progress is still needed if the exchange rate mechanism is to function smoothly. The first is the practice of realignments.

Negotiation of realignments has usually been tense, political, and geared toward domestic political benefits, illustrating the difficulty of managing smooth realignments in a system of adjustable rates. The second area is asymmetry. In the end, the burden of intervention, and of adjustment, still falls primarily on countries that have deficits or weak currencies.

The authors examine the G7 process and find it flawed—by lack of clarity, unclear commitment, contradictory signals from participants since the original Plaza agreement, and failure of monetary cooperation. Most of all, they find, the objective of stabilizing the value of the dollar needs further thought and qualification. The major failure of the process, in their view, is that it has largely neglected to back up accords on exchange rates with commitment to domestic adjustment. Here they criticize the United States for making the overvalued dollar, together with the policies of other countries, the scapegoat for its balance of payments problem.

Concluding their examination of coordination, Jacquet and de Montbrial focus on the perpetual debate between internationalists and those they call domesticists. The latter highlight the need for everyone to put his house in order; the former concentrate on the requirements for collective management. Effective constraint on governments may be instrumental in facilitating reasonable domestic economic policies, but governments generally will accept only those constraints that they feel are in their national interest.

If an international anchor is to be provided, these authors find, some clear rules to make the anchor visible are needed; rules on exchange rates may be the most palatable. The system itself has to be both stable and flexible, with a commitment to specified, public targets; a commitment to fiscal as well as monetary cooperation; and a process for adjusting the targets. Finally, the authors conclude that true international economic cooperation, requiring political will and commitment, will not take place for an indefinite time to come.

A comprehensive examination of the scope, methods, and effects of international coordination is undertaken by Jacob A. Frenkel, Morris Goldstein, and Paul R. Masson, in the concluding chapter of *International Money and Debt*. Asking why international policy coordination would be beneficial in the first place, they answer that economic policy actions, particularly those of larger countries, create quantitatively significant spillover effects—or externalities—for other countries and that such externalities should be taken into account in decision making. Coordination is then best seen as a facilitating mechanism for internalizing these externalities.

The authors emphasize departures from the competitive model in today's global economy and find one role of coordination to be preventing or minimizing intentional or unintentional beggar-thy-neighbor practices (most international monetary constitutions have injunctions against manipulating exchange rates or international reserves). Recognizing the existence of public goods, the authors also find a positive role for coordination in identifying inconsistencies between the various targets of economic policy and resolving these inconsistencies in ways that produce enough of these public goods.

The presumption that there can be benefits from coordination is reinforced by two empirical observations.

- The world economy of the early 1990s is considerably more open and integrated than that of previous postwar decades. With larger spillovers, there is more at stake in how one manages interdependence.

- There is widespread recognition that the insulating properties of floating exchange rates are more modest than was suspected before 1973.

Formidable obstacles sometimes exist to implementing coordination.

- If some policy instruments are treated as ends in themselves, international policy bargains that involve shared objectives can be frustrated.

- There can be sharp disagreements among countries about the effects that policy changes have on policy targets.

- There remain huge cross-country differences in openness and interdependence. Large countries, such as the United States, are generally less affected by other countries' policies than are small ones.

- As a national priority, international bargaining typically ranks below domestic bargaining.

In examining the scope of coordination measures, a key question is the appropriate range and depth of policies to be coordinated. A wide-ranging approach to coordination increases the probability of achieving policy bargains that benefit all parties. Such an approach also generates favorable spillover effects between issues, and allows negotiators to coordinate trade and structural policies as well as exchange rate and demand policies.

Arguments for a narrower approach, on the other hand, are that negotiation costs rise rapidly as issues proliferate, that implementation is more problematic as jurisdiction expands, and that disputes on some issues can frustrate the chance for agreements in other areas. Further, coordination may be likely only in the specific areas where there is a consensus on the effects of common policies.

In view of these conflicting considerations, the authors approve present institutional practices on the range of coordination—practices that entail high-frequency coordination on narrow issues in a multitude of forums (such as the IMF and GATT); less frequent and wider coordination at a higher level in more limited forums (such as the IMF's Interim Committee); and even less frequent, still wider coordination at the highest level (heads of state and government at the economic summits). The authors also consider the depth of coordination, finding greater specificity to be desirable, for both fiscal policy and structural policies.

On the question of when to coordinate, the authors' view is that both the likelihood and effectiveness of coordination will be enhanced when it is a regular, ongoing process.

- Having many bargaining periods expands the opportunities for policy agreements.
- As suggested in the literature of game theory, the existence of repeated bargaining strengthens the role of reputational considerations in coordination.
- Once coordination is established as a routine process, there is likely to be more freedom of policy maneuver for all participants than when negotiations are conducted in a crisis atmosphere and when disagreements may be seen as signaling the collapse of coordination itself.

Frenkel, Goldstein, and Masson discuss methods of coordination with particular attention to whether coordination should depend on rules or discretion.

The case for rules rests on the arguments that rules could eliminate most of the negotiation costs and burden-sharing conflicts intrinsic to more discretionary systems. Rules are also a visible mechanism for imposing discipline, and they can enhance the predictability of policy actions. Finally, by preempting destabilizing fine tuning, rules can provide protection against ignorance of how the economy operates.

There are a number of counterarguments in favor of a discretionary approach. To begin with, rule-based systems often turn out to be less automatic in practice than in theory. Moreover, rules will impart discipline only to the extent that penalties can ensure that the rules are followed, and it is not clear that rules are necessary to obtain the benefits of greater policy predictability. Finally, although rules diminish the risk emanating from fine tuning, they increase the risk stemming from lack of adaptability to changes in the operating environment.

The authors consider whether there should be a single-indicator or multi-indicator approach to coordination.

Two main considerations are typically advanced to support a single-indicator approach. One is that it avoids overcoordination; the other is that it sends a clear signal to markets about the course of future policy. The risks of a single policy indicator can be substantial, however. A single indicator can send weak, or even false, signals about the need for changes in other policies, as the authors illustrate through descriptions of errant fiscal policy under fixed exchange rates or target zones.

A multiindicator approach to coordination should not be susceptible to the weak- or false-signal problem, because such an approach goes directly to the basic stance of fiscal and monetary policies, rather than passing through the medium of the exchange rate. In such an approach, however, the requirement of consistency can take on added prominence.

Another key issue associated with coordination is whether systems should be hegemonic or symmetric—that is, whether one country should have a predominant voice in the course of policies or whether that influence should be shared more evenly. The authors find that although there have clearly been periods when large countries have exerted a stabilizing influence on the system, it is hard to accept that hegemony is a necessary characteristic of a well-functioning system of international coordination.

- Careful study of alleged hegemonic systems, including the gold standard, reveals that the amount of cooperation needed for smooth functioning was substantial.

- Much of what passes for the stabilizing influence of hegemony can also reflect common objectives, as in the EMS.

- Attempts to reinstate a hegemonic approach when economic realities no longer support it could be counterproductive.

Frenkel, Goldstein, and Masson conclude their chapter by considering coordination when effects are uncertain. They specify, first, that lack of knowledge about the functioning of the world economy—model uncertainty—should be distinguished from disagreement about the correct view of the world, which may or may not involve recognition by policy makers that their view may be incorrect.

They consider several attempts to use model simulations to evaluate the effects of policy coordination and observe that these attempts, which conclude that gains for the major industrial countries are likely to be small, may not give an adequate assessment.

- The range of disagreement among the models compared in at least one study may be larger than that between policy makers.
- Policy makers' views of reality are more subtle than those represented by the models, and policy setting cannot be represented by such simple exercises.
- From a comparison of optimal uncoordinated with optimal coordinated policies, it may not be possible to generalize to the more relevant comparison of suboptimal policies.
- Some of the gains (but also no doubt some of the losses) from coordination may be unobservable (unwritten pledges to alter policies in the future) or may be difficult to separate from less ambitious forms of cooperation (exchange of information across countries) or may extend beyond the realm of macroeconomic policy.
- Gains from coordination may appear small in comparison with some optimal standard or in relation to costs, but that does not imply that these benefits are not worth obtaining.
- Empirical estimates of gains from coordination have typically compared policies that do not exploit the incentive governments have to adhere to agreements to enhance their reputations or their credibility.

The authors retain their conviction that international coordination of economic policies promotes global welfare.

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These individutals contributed to the volume *International Money and Debt*, from which this executive summary is taken.

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