Challenges Facing the International Monetary System

Paul Volcker

THERE ARE CRITICAL AND UNRESOLVED ISSUES STARING US IN the face in all the important areas of international economic policy—monetary, trade, and development. The economic crisis in Mexico made the point. A nation looked to as a prime example of the success of the new consensus favoring open, privatized, market-oriented economies suddenly found itself in deep trouble. Yet, even in areas where problems arose less abruptly—elsewhere in Latin America, in Central Europe, in the former Soviet Union—instability is rife and growth disappointing.

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The G-7 does not appear able to convincingly solve these problems. It is indispensable for the G-7 to maintain an emphasis on the need to find common ground, to work constructively around the edges of the evident problems, and to provide an environment encouraging further efforts. However, strong new initiatives capable of restoring a sense of fresh progress and assurance of greater stability are hardly likely.

The simple fact is, inside or outside governments, there are no dramatic new ideas that command anything like an intellectual consensus or enthusiastic public support in the fields of money, trade, or development.

We have, of course, had rapid and fundamental change in these past few years—the triumph of dramatic capitalism in almost all parts of the world to almost universal acclaim. The progress made in restoring a sense of price stability, a key ingredient for lasting economic progress, is admittedly impressive. In the past couple of years, we have seen renewed expansion in world trade, supported by agreement on the Uruguay Round and NAFTA. We have seen particularly promising reforms in Latin America. Despite the difficulties, we have hopes for Eastern Europe.

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In the United States, we have benefitted from solid expansion. We have the lowest level of unemployment in decades, high capacity utilization, and high profits. Even so, we have not broken the habit of saving too little, and like many other countries, running deficits that are far too large.

Now our economy has slowed, thus removing one engine from the world economy. This is not good news at a time when European recovery is clearly incomplete, with unemployment averaging over 10%. In Japan, growth has been almost nonexistent for several years, the country's most sluggish performance since World War II.

On a more disturbing note, the sudden and unexpected economic debacle in Mexico not only gave rise to hardship and uncertainty there, but raised questions about prospects for stable growth in other modernizing, emerging economies. Ironically, just as we should be luxuriating in the political and negotiating triumphs of NAFTA and the Uruguay Round, we see an intensification of old trade disputes, at least between Japan and the United States. As a result, the proud negotiating triumph of the new World Trade Organization is at risk.

In short, economic performance as we approach the end of the 20th century has not matched—not yet anyway—the rhetoric that has surrounded the triumph of old-fashioned liberalism, open markets, privatization and the priority on price stability. This could be a measure of the intellectual and practical bankruptcy of the socialist-interventionist-central planning model of economic development where, even in areas of severe stress—Mexico, Russia, some parts of Eastern Europe—there seems to be little interest in returning to that approach.

At the same time, there is not much ground for complacency or self satisfaction. If our expectations about the G-7 in the near future should be properly modest, let there be no mistake. There is a large limited agenda for the future if we are to make the promise of our rhetoric a reality.

Take the monetary arena. In an immediate sense, Mexico underwent a monetary crisis. What in retrospect seems an increasingly overvalued currency was supported for several years by huge voluntary, even enthusiastic, inflows of capital looking to maximize returns. Growing portions of that capital reflected direct investment by international businesses and the repatriation of Mexican capital. Those were signs of confidence and health. The part that was not so healthy was the heavy and growing reliance on short-term money to finance a huge current account deficit even though economic growth was restrained—an ominous development. Respect for the policy reforms initiated by Mexico, and for the progress against inflation, helped to account for the inflow. But toward the end, concerns by lenders and borrowers alike were lulled only by the apparent protection against exchange rate risk provided by new borrowing instruments.

When the exchange rate adjustment was finally attempted—and without an adequately strong economic program to back

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it up—things quickly got out of hand. The widely diverse short-term lenders wanted their money back, exchange rate protection or not. The exchange rate sank beyond all expectations as once seemingly ample reserves were dissipated.

The resulting crisis set off a new round of inflation, threatened the Mexican banking system, and threw the economy into deep decline. More than that, the Mexican example threatened the stability of other emerging economies in Latin America and elsewhere.

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Mexico was not the first, and it won't be the last, financial crisis aggravated by the increasing amounts of highly mobile capital available in today's world. Yet, unlike the crisis of the early 80s, the money involved was not, in really significant amounts, from banks. Rather it was spread among a large number of anonymous investment institutions seeking near-term maximum returns, but with no continuing business relations or commitment to Mexico.

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The good news is that the absence of heavy bank involvement minimized the threat to the international financial system.

The bad news is that the variety of sources and their lack of any real attachment to Mexico made it virtually impossible to coordinate a largely voluntary rescue and financial program, as was done in the 80s.

Instead, the United States and the IMF stepped into the breach with, by all previous standards, an enormous pledge of official short and medium-term money. Together, they virtually assured payment of the foreign short-term investors, however imprudent they had been.

This is not a precedent that many would want to see repeated. The palpable reluctance of countries outside North America to assist Mexico suggests that, in all likelihood, this experience will not be repeated.

The G-7 will no doubt renew old calls for more active surveillance of borrowing countries, and for large quantities of and more frequently published statistics. More controversially, some reinforcement of IMF liquidity will be proposed so that the Fund itself will be better prepared to act in the next crisis. However, there is likely to be little willingness—even by the US—to provide the IMF with access to resources comparable to those provided directly to Mexico by the US Government.

Greater surveillance and transparency along with more (but still limited) official resources should theoretically provide an adequate answer to the threat of extreme volatility of short-term capital—but they don't. The basic problem with respect to Mexico was not any failure by sophisticated market participants to realize that Mexico had a massive current account deficit and exceptionally heavy reliance on short-term financing. The failure was one of interpretation, together with a natural reluctance in an uncertain world, by either official or respected private analysts, to precipitate risk. An enlarged reservoir of official financing would be counterproductive if it only serves to encourage complacency among borrowers or lenders.

The Mexican experience raised larger issues that are not relevant to emerging economies alone.

Central banks and governments must indeed act to deal with a generalized threat to the stability of the banking system, be it national or international. That is a clear lesson of history, acted upon by virtually every country. Yet, to encourage other lending institutions or financial intermediaries to feel that they can call on the same degree of support could well be a mistake.

With the function of banks and other institutions overlapping so broadly, that conceptual distinction raises a lot of practical questions in today's complicated world. But in the end, we will not have properly restrained behavior in private markets until risks are perceived to be commensurate with returns. Perhaps the Barings affair will help drive the point home.

There has been growing discomfort over controls on international capital, for good and valid reasons. These are now a rarity. However, that general and healthy attitude can reasonably allow for exceptions. Specifically, experience suggests that countries seeking to discourage inappropriate and highly volatile flows of short-term portfolio capital may find some forms of regulation useful.

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That approach would be wholly inappropriate for the United States, given its size and the international significance of its currency and money markets. Other large countries with well-developed markets are likely to feel the same way. The situation is different for much smaller emerging economies with less flexible markets. In these cases, amounts of capital easily absorbed by a large developed country can literally swamp limited domestic financial markets, lead to sudden and inappropriate changes in exchange rates, and destabilize the economy.

The volatility of exchange rates is, of course, a problem for the entire international financial system, not just the small and

emerging economies. The recent changes in the dollar/yen rate, for instance, seem inexplicable in terms of relative prices or changes in economic circumstances or policies. Nonetheless, there seems to be a good deal of complacency about even large exchange rate fluctuations among governments and the private sector as well.

After floating exchange rates were adopted in the early 70s by leading countries, exchange rates were extremely volatile. This was commonly attributed to the need for a learning period for markets and to exceptional economic policy disturbances and inconsistencies due to the oil crises of the 70s. The free play of markets, or so it was felt, would in time produce exchange rates fluctuating fairly narrowly around some equilibrium trend.

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It reads convincingly in the textbooks, and in ardently argued essays. Yet, here we are, 20 years later, surely enough time for even slow learners to become educated. Moreover, economic policies and national economic performances converge about as well as we could expect among sovereign nations. However, every time we have a quiet period in the exchange markets, it seems to be followed by a renewed period of volatility as bad as that of the 70s.

Some people ask what difference it makes when compared to the cost of doing something about it. The world goes on; trade is increasing. But investments are distorted and growth in productivity has slowed. It seems strange that we spend enormous amounts of negotiating energy and political capital to reduce already low tariffs by a few percent, presumably in the interest of economic efficiency, only to see the effects of lower tariffs swamped many times over by changes in exchange rates—changes seemingly unrelated to differentials in inflation rates or other competitive factors.

In Economics 101 we learn about the glories of comparative advantage. But what can comparative advantage mean among developed economies broadly competitive over a wide range of goods when exchange rates can shift by 10 or 20% over a few months? And what are the risks of volatile exchange markets transmitting inflationary or recessionary impulses? Can the floating exchange rates really, in the end, protect the autonomy of national policies?

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Obviously, raising these questions is much easier than finding ways to answer them.

There isn't any doubt that stability in exchange markets cannot be obtained "on the cheap"—by simply announcing stability as an objective or even by official willingness to buy and sell large amounts of currencies in the market place. The private markets are simply too cynical and too large for that—collectively, those markets have far larger resources than governments can command.

Experience has amply demonstrated that, to be credible and effective, governments must bring to bear the heavy guns of policy—most immediately monetary policy, but also fiscal policy and perhaps other measures—if they want to stabilize exchange rates. Therein lies the difficulty.

Monetary policy, conceptually and practically, can be particularly important. We have seen that in practice. However, we also know that using monetary policy to stabilize exchange rates will at times be perceived as contrary to the interests of the domestic economy. That perceived—and sometimes real—conflict can be ameliorated by bringing fiscal policy to bear. But there is hardly an advanced democratic country that feels technically or politically able to conduct a flexible fiscal policy. Most of them are struggling hard to restore some semblance of credibility in moving toward medium-term balance.

Understandably, governments are reluctant to undertake commitments to stabilize exchange rates when they cannot predictably control their own policy instruments. The situation is greatly complicated politically by the large vested interest that has developed in the volatility of exchange rates in private markets. The fact is trading revenues have become an important profit center for banks and other financial institutions. As a result, an important natural constituency for stability in earlier times is simply gone.

The losers are the commercial firms—the importers and exporters—and, probably even more so, longer term investors who cannot practically or efficiently hedge their plant and equipment expenditures or the expense of developing foreign markets. For most of them, exchange uncertainties and losses are not the main costs of business—they are nonetheless a real problem. Many will adjust by engaging in "defensive" investment, in the sense that they tend to produce where they sell, avoiding some exchange rate risk in that way. Yet, that kind of response does not really follow the textbook maxims of exploiting comparative advantage or maximizing productivity.

In these circumstances, we can hardly expect an important breakthrough in thinking or policy on the exchange rate problem. In Europe, the instinct to drive toward a common currency seems correct. In time, more aggressive efforts to achieve stability among North, and even South American currencies seems in order—even if that approach has been anathema to Canadian authorities in the past. On a multilateral basis, there should be some sort of loose target zone system among the tripolar regions—Europe, Japan, and North America.

For now, that is only a dream, not something to be discussed at G-7 summits in the near future. Furthermore, those summits are unlikely to go far toward defusing the chronic trade tensions between Japan and the US, or solving the conceptual and financial questions surrounding development policy.

What the summits can do, and will do by their very existence, is remind us all of our interdependence. In doing so, they should reinforce the will to deal with these intrinsically international problems collectively.

Without that will and conviction, all that bright promise of economic growth, development and freedom emerging from the triumph of democratic capitalism would indeed be in jeopardy. ◆