Is there an international monetary system?

Remarks by Mr C. W. McMahon, an Executive Director of the Bank of England, to the Financial Times Conference on World Banking in 1978

Members of the official international community are much given to talking of 'the international monetary system'. Alternative phrases such as 'the international monetary situation' or 'the present international monetary arrangements' are unattractive to say or to listen to, and are not much favoured. But in using the word 'system' year in, year out, regardless of what is actually going on in the world, we comfort ourselves and flatter reality. Perhaps the little extra reassurance we give ourselves that there is always some underlying order, is harmless enough — heaven knows, we all need a little reassurance. But we do long-run injury both to speech and thought by debasing the idea of an international monetary system. We make it seem an easier thing to achieve than it actually is, so that the breakdown of one system can be thought of as inevitably leading to another.

In this connexion it has been well remarked that if your car loses a wheel it is of little use to rechristen it a tricycle.

What are the essential qualities of a stable and enduring international monetary system? First, of course, it must be soundly economically-based and coherently articulated. But, almost as important, it must be soundly politically-based. Economists often seem to forget that the world economy is not just an aggregation of international trade, payments and assets; it is also the agglomeration of independent governments. All the time, for better or worse, governments are making economic and monetary decisions affecting the welfare not only of their own citizens but of those in other countries. Any international system must be such as to accommodate as fully as possible the wishes of sovereign governments and the domestic political pressures on them to affect the welfare of their own peoples. But this will not be enough, because aims will often be in conflict. There is also the much more subtle requirement that a system should ensure that as far as possible the ways in which governments and central banks may reasonably be predicted to behave will be in some sort of harmony — or more realistically, that incompatibilities of aims will be minimised. There should be some sort of penalty to deter unco-operative or internationally antisocial behaviour.

In practice, therefore, the essence of any international monetary system must be the existence of constraints on sovereign behaviour. It might seem at first sight that one system favoured by many groups of economists — pure floating — fails to meet this criterion. But a little reflection shows that this is not so. The intellectual case that pure floating maximises the world's welfare may or may not convince you. But the essential point to operating a regime of pure floating is that all authorities — at least all the important ones — commit themselves to refrain from any intervention in the exchange markets (or, perhaps, to intervene only to counter disorderly market conditions). In practice, this essential commitment to passivity by governments and central banks is seldom made even in principle; and when it is made it is seldom carried out *à outrance*. Paradoxically, the constraint which free floating imposes is so severe as to be unacceptable. However, once substantial but unpredictable amounts of intervention are being carried out, we are immediately carried a crucial distance from the underlying economic philosophy of a floating-rate system.

It is in practice extremely difficult to get all the world's governments to agree on any set of constraints on their behaviour — and then to stick by their commitments when the going gets rough. For this reason the world has perhaps only twice had what could properly be described as an international monetary system in modern times: the gold standard and the Bretton Woods system. Both of these may be said to have worked effectively as systems for a considerable time, though both had periods of decadence during which they ceased to work satisfactorily, while they were breaking up.

Why, in these two instances were governments willing to accept the necessary constraints — primarily on their freedom to alter their exchange rates? This constraint was of course much more absolute under the gold standard than under Bretton Woods; but under both systems it could involve irksome and difficult policy actions which were damaging in domestic economic and political terms.

It is difficult to escape the feeling that under the gold standard the acceptance of the rules owed a lot to a widespread belief that the constraint simply could not be rejected.Even at the very end of the system, when the British National Government went off gold in 1931, one of the members of the ex-Labour Government remarked: 'They never told us we could do that.' Whether this was strictly accurate or not, it provides a striking illustration of the force which unchallenged assumptions about possible behaviour can have on policy. Or, perhaps one should say, the force which such arbitrary rules could in the past have on policy.

The more widely it becomes realised that it is possible to break the existing rules the less force — both for good and ill — they necessarily have. Once society has, as it were, eaten of the apple of knowledge there is no returning to its previous state. It is natural that arbitrary rules should be questioned — and, if their consequences are clearly damaging, that the rules be broken. But the consequences of the newly-acquired freedom may not be as attractive as they appear beforehand.

If we look back over the international monetary history of this century, I think we can detect an oscillation between more regulated and less regulated periods. Anyone who believes that history tends to repeat itself can predict with a good deal of conviction that we shall revert to a more regulated set of arrangements. But that facile prophecy evades the crucial question: what will be the appropriate set of rules for the post-floating period?

In any event, the experiences in the 1930s of the absence of any international monetary system were somewhat disillusioning. Hence in 1944 an attempt was made to restore the constraint of exchange rate stability, though in a much less absolute form.

Bretton Woods is interesting as the only example in history of a world-wide monetary system embodied in treaty form with fully explicit constraints on the behaviour of all members. In its later years, the system had, as the phrase is, a mixed press; and it certainly had a number of defects which became more serious as time went on. But with hindsight it is difficult not to regard it as having been a major success. It was surely not coincidental that in the roughly twenty-five years during which it was in operation the world saw a sustained expansion in production and trade on a scale seldom recorded before, with, on the whole, low rates of inflation. Recovery from the devastation of war was achieved remarkably swiftly and without the inflation and deflation that had followed all previous major wars. Trade was almost uninterruptedly and almost everywhere liberalised. What were the reasons for this success?

Doubtless there were many favourable circumstances — though only some of them were fortuitous. The relatively successful performance on inflation — relative to what we have had since at least, if not to what went before — must have had other causes; but the fact that inflation was generally low, and that therefore differences in inflation rates between countries were small, undoubtedly helped to sustain the system itself and to foster the expansion of activity. I would also argue, however, that the comparative certainty of operating in a world which accepted a presumption of stable exchange rates was itself conducive to higher activity, and especially to higher investment.

For a long period there was relatively little problem with large mobile investible funds. This was partly chicken and egg. The exchange rates were for some time thought to be capable of being held stable for long periods so that speculative forces were slow to grow. But it was also the case that, compared with the present day, there were fewer large multinational firms, much less sophistication in the management of international funds, markets were less deep and wide. Here, too, irreversible changes have taken place. We could not now return, even if we wished, to a situation in which the size of internationally mobile funds was reduced to the levels of say the 1950s.

I believe, however, that the success of the Bretton Woods regime was due primarily to a fact more interesting, perhaps more fundamental, than these. At the heart of its early success lay the feature most severely criticised in its later stages: the asymmetry of the system and the unique rôle played in it by the United States. At the end of the war, and for many years thereafter, no other major country remotely approached the size and power of the United States; and she exercised this power in a strikingly beneficent and far-sighted way, which actively fostered the development of the rest of the industrialised world.

One particular way in which the United States performed this function was to run a basic deficit. This had an important consequence. It meant that all other countries taken together could be in net surplus. Now for a number of reasons industrialised countries prefer on average to be in surplus rather than deficit. This is not so much that their governments are always mercantilist in the often pejorative sense of perversely wishing to acquire gold or paper instead of letting their citizens enjoy to the full the goods and services they produced. There are more practical considerations. A country is likely to enjoy much greater independence in terms of policy formation and security for the future if it is in surplus rather than deficit. It is likely to be easier to maintain employment and investment in these circumstances. If the country is efficient and dynamic, it is likely to be able to build a virtuous circle for itself from the development and export of goods for which demand is expanding most rapidly.

For all these reasons an arrangement which enabled countries on balance, taking one year with another to be in surplus was likely to be a stable one, facilitating expansion and liberal attitudes towards trade. In the jargon of the games theorists, we had in the rest of the world 'a positive sum game'. The counterpart of this was, of course, that most countries were acquiring reserves primarily in dollars. In due course, as these claims on the United States grew and US deficits continued, concern gradually increased about the value of these claims and the question came to be increasingly sharply put as to whether or not the United States would undertake in practice the obligation of convertibility into gold which was theoretically the rôle she assumed in the system. For many reasons, the United States decided against taking the steps necessary to maintain the convertibility obligation and the system broke down.

It would, however, probably have broken down in any case, because the problem of the growing claims on the United States was only one aspect of a more general development. The absolute pre-eminence of the United States compared with all other countries was being replaced by something significantly closer to equality — though still far, far from equality — among a number of major powers. This fact, again irreversible, has had important consequences, many of them still with us. The difficulties of formulating and managing a coherent international monetary system, always great, are in present circumstances particularly severe.

It may be possible for a set of roughly equal powers to devise, and abide by, a set of rules constraining and benefiting each equally. It may be possible — indeed it was achieved at Bretton Woods — to devise a set of rules which appears in the abstract to apply to each country alike, but which in practice enables one very different power to behave very differently from all the others. It is fairly obvious, however, that it will be difficult to devise and abide by rules which constrain appropriately a group of major but unequal powers. As is well known in business theory, oligopoly produces an indeterminate situation for which it is hard to legislate.

For better or worse, then, the Bretton Woods system broke down and the world moved, despite several rearguard attempts to prevent it, to a regime of virtually total floating. The United States became instead of (or rather as well as) the banker, one of the participants. In the terms of our earlier metaphor, instead of a 'positive sum game' we moved to a 'zero sum game'. Everybody's surplus was now somebody else's deficit. It will be clear by now that in my view this state of affairs, whatever its apparent economic advantages, is likely to involve rather sharp policy conflicts between nations. It may be possible to codify some rules of behaviour for such a system (remembering that the participants are of very unequal power, which is bound to add to the difficulties) and indeed attempts have been made in the reformed International Monetary Fund Articles to do this. Those attempts might be thought to illustrate just how difficult it is to devise rules which are both generally acceptable and have some significant influence on behaviour. *A priori*, one would indeed expect more explicit conflicts between national policies and therefore more self-regarding and general welfare-reducing actions to be taken.

Apart from the experience of the 1930s, however, we have little to go on to help us decide whether this view of floating is the right one. The world had only just embarked on these arrangements when the financial earthquake of the quadrupling of oil prices occurred.

Since then there has been an unrequitable surplus in one part of the world with a corresponding irremovable deficit spread over the rest. The world outside OPEC has been plunged into a 'negative sum game'. Individual nations, with no defined rules for exchange rate policy, or indeed, balance of payments policy generally, have been competing for an overall deficit. It is not difficult to see the *a priori* likelihood that this will lead to cumulative deflation, national recrimination and pressures for protectionism.

It is easy enough to analyse academically the consequences of an aggregate, unrequited surplus in one part of the world; and to say, as the world's financial statesmen have repeatedly said, that the overall deficit must for the time being be accepted. But it is extremely difficult on any theoretical grounds to decide how the deficits should be shared out; and in the absence of any international sovereign body which can impose its will, it has not been possible to press for any particular pattern of deficits, however arbitrary that would in any case have been.

Since inflation was everywhere already running at high and dangerous levels at the time the oil price rose, most countries felt forced sooner or later to take restrictive monetary and fiscal measures as part of a counter-inflationary policy. This was probably right — indeed essential — but it further bedevilled the aim of accepting the aggregate deficit.

In practice, countries differed in the timing and effectiveness of their domestic anti-inflationary policies; and some countries, regardless of the overall problem, decided it was of paramount importance that they themselves should adjust quickly so as not to be put in the insecure position of being in deficit.

The results of all this are plain to see. Imbalances within the non-OPEC world among the major countries have actually increased, adding to the pressures caused by the OPEC surplus on the rest of the world, particularly the smaller industrialised and the developing countries. Exchange rates have moved very widely. Recently, the most striking fluctuations have been those between the dollar and most other major currencies, reflecting in part the present large surpluses and deficits. But there has been instability elsewhere too: it is difficult to see the underlying significance of the rise of 15% in the value of the Swiss franc in relation to the deutschemark over the past five months; or to understand what kind of adjustment is being fostered by it.

Inflation, though everywhere below its worst levels, is still almost everywhere too high. Together with the instability of exchange rates, it continues to act to sap the confidence of consumers and businessmen alike, exacerbating the already seriously depressed state of activity throughout the world. Not surprisingly the pressures for protectionism are steadily growing.

Pretty clearly we have nothing that can be called an international monetary system at present; the situation is unstable and fraught with considerable danger. In what direction should we look in trying to determine any steps we might take towards re-establishing a system — or short of that at least reducing the possibilities for disharmony and conflict?

Some see as the most urgent need the elimination of the large surpluses within the non-OPEC world. Those who take this view tend to be frustrated by the stubbornness with which these surpluses persist, or even grow, and the lack of any effective international leverage on surplus countries.

The difficulty of securing some degree of even-handedness of treatment between surplus and deficit countries is in fact an old problem — much discussed in the late stages of the Bretton Woods system and during the deliberations of the Group of Twenty. In operational terms the most important function of the IMF has been to provide medium-term support for countries in deficit. It has naturally normally been the aim of such support to help the countries concerned to return to balance: and policy conditionality has therefore usually been attached to the support advanced. At present, in the context of a necessary overall deficit, there is a serious question mark over this traditional approach, since clearly all countries cannot be brought back to balance. Added point has been given therefore to an often expressed wish to exercise some constraint on countries in surplus.

The Bretton Woods agreement contains, as is well known, the so-called scarce currency clause for this purpose; but the clause has never been used and it is hard to see how in practice it could be. Some people believed that the move to floating rates would achieve the desired aim and that adjustment of both surpluses and deficits would result from a free appreciation and depreciation of currencies.

In practice, however, it has not proved so simple. Adjustment under floating rates has not yet been satisfactorily brought about; and it looks increasingly implausible to say that it is simply a question of our being prepared to wait long enough. One reason for the lack of success is probably that it is proving more difficult than many believers in floating rates had expected to bring about alterations in real exchange rates. Large appreciations and depreciations of nominal rates have occurred: but there has been a systematic tendency for the cost effects to feed through relatively quickly so that inflation has tended to improve in the surplus countries more than in the deficit countries. There appears to be a tendency to polarisation going on in the world, with the strong getting stronger and the weak weaker. Deficit countries, especially those with a high degree of wage indexation, find it hard to take measures that will allow their exchange rate depreciation to produce balance of payments improvement rather than domestic inflation. Surplus countries, on the other hand, perhaps largely because of their fear of inflation, tend to be unwilling to expand their domestic demand sufficiently to make rapid inroads into the surpluses.

Some people are so impressed by the difficulty of making early progress in reducing the surpluses that they lay greatest stress on attempting to ensure that the surplus countries will enable the corresponding deficits to be financed. This would mean in practice that the surpluses would need to be offset by capital outflows; and not merely in the accounting sense that every current account position is always financed in some way by movements in the opposite direction in the capital account. What would be required would be sustainable flows of long-term capital of a kind that maximises the ability of deficit countries to keep up their own domestic levels of activity, and especially investment. It will be desirable, and it may become crucial, that the flows are in forms which do not significantly impair the credit-worthiness of the recipients. Examples would include development aid, contributions to multilateral financial facilities such as the Witteveen Facility or private long-term capital outflows in the surplus country's own currency.

Finally there are the arguments of those who say the prime need is to stabilise the world's currencies. The case here centres primarily on the dollar, and the argument runs that our difficulties stem from the fact that, as it was put earlier, the United States has taken a place as a regular participant in the adjustment game while continuing her rôle as the banker. Movements in the dollar exchange rate that might be justified on balance of payments grounds become dangerous, it is argued, in the effects they have on the value of what is effectively the world's only reserve asset. In a sense, those who argue in this way are asking whether in the long run and in the light of developing changes in relative power, the United States will be willing to continue alone to shoulder the burden of providing the world's reserve assets.

Those who think the prime need is action by the surplus countries would argue that if appropriate stimulus were given in these countries, currency stability would quickly follow. Those who want action directly to stabilise currencies, believe that this would quickly produce, through improved confidence, benefits in higher activity and more stable financing of deficits. Both sides may be right; though perhaps neither is seeing more than a part of the truth. But the important point perhaps is that in the present conjuncture, all countries are finding it difficult to embark on the policies that other countries are eager to recommend to them.

In the absence of any international system there are no uniform rules laying down the appropriate behaviour for all countries alike. And there is no guarantee that the free operation of market forces will be conducive to the appropriate behaviour of individual governments and the development of individual economies. Nor is any one country in a position to determine the outcome for the world as a whole.

Each country, seeing the world from its own standpoint, more aware of its own political, social and structural economic problems than its critics outside, is reluctant to act alone. The inescapable conclusion is that the major powers of the world will have to feel their way towards some common agreed set of policies. In doing so, I am confident that in due course they will create a new system.

It will not, however, be the sort of system which can be written down as a set of rules on a blank piece of paper. It may be relatively uncodified and it may look untidy. Its essence will be some form of mutual sharing, between major but unequal powers, of the responsibilities for adjustment, finance and reserve creation for the world as a whole.

We shall have to seek to steer an evolutionary process, catching any helpful tides and avoiding the all-too-visible rocks. Whilst I do not want to minimise the difficulties, there are, I believe, reasons for taking a soberly hopeful view. The very dangers and difficulties of the present situation are concentrating all our minds. More thought is being given to how we can fit together the different pieces of the present jigsaw of arguments. There is, I believe, despite all the name-calling and finger-wagging, a growing appreciation that more co-ordination and new forms of co-operation between sovereign states will be necessary. This is the tide we must catch.