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Remarks by M. Camdessus
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in delivering the 1988 C.D. Deshmukh Memorial Lecture
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The Evolving International Monetary System: Some Issues

It gives me very great pleasure to be in India. It is a particular delight to come first to Bombay, a city which from the beginning has been one of the meeting points of the world. And it is comforting this evening--former central banker that I am--to find myself in the congenial clutches of the Reserve Bank.

It is also a distinct pleasure, and indeed a rare honor, to have the opportunity to give the fifth C.D. Deshmukh Memorial Lecture. Dr. Deshmukh was not only highly esteemed in this, his own country. He also made a very considerable mark in international financial circles, particularly in those heady days forty to fifty years ago when a new monetary order was being fashioned and nurtured. As a member of the Indian delegation to the Bretton Woods Conference, Dr. Deshmukh played a crucial role in shaping India's attitude to the Bretton Woods institutions. Subsequently, as Governor for India on the Board of Governors of the IMF and World Bank during the formative years of the two institutions, he was instrumental not only in safeguarding India's interests and speaking out for other developing countries, but also in fostering sound traditions of international monetary cooperation.

Dr. Deshmukh stood four-square for multilateralism, for measures to promote the expansion of international trade, for freedom for capital to move to its most productive use. He did so in both words and deeds. In his valedictory speech at the inaugural meeting of the Board of Governors of the Fund and Bank in Savannah in March 1946, he gave, on India's behalf, an important pledge:

> "... that we shall give of our best to the Fund and the Bank and that we shall choose men who will play their part worthily, with dignity and independent judgment, and we shall see that they are placed in a position to give to these institutions the time and attention that the interests of the institutions demand."

It is a pledge that was kept. And it continues to be kept. The Fund is stronger for it. And we are grateful.

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In my remarks this evening, I should like to look at the world monetary system, and in particular to focus on a number of aspects of the system that have long been of concern to this country. Other, perhaps more obvious, topics had of course suggested themselves. I settled on this subject, however, quite deliberately: first, in honor of Dr. Deshmukh's commitment to internationalism; and second, in tribute to the intellectual contribution that this country has made--and I hope will continue to make--to the process of international monetary management.

It is also a timely topic following the Fund's Annual Meeting in Berlin, where a number of speakers encouraged us to look at possible ways of improving the functioning of the international monetary system.

I should not, though, want this occasion to pass without saying a few words about policies and developments here in India. Let me first record our appreciation of the tradition of close cooperation between your Government and the Fund. India is an excellent example of a country that approached the Fund when incipient balance of payments difficulties first became evident in the early 1980s. The strong efforts you made then were remarkably successful; in fact, the external position strengthened beyond expectations, and India was able to forgo the use of a sizable portion of the financial resources that had been committed by the Fund.

Since then, India has continued to pursue cautious financial policies and has avoided the debt-related problems experienced by many developing countries. Structural reforms, meanwhile, have contributed to an acceleration of growth during the 1980s. Even in the face of an exceptionally severe drought in 1987, you coped well, managing to avert the most devastating social consequences and to maintain the momentum of industrial and export growth. It remains necessary, of course, to continue--and indeed to speed up--the structural reform process, and the Government's commitment to this course is most welcome.

These various accomplishments have placed India in a sufficiently strong position that it has indicated it does not expect to borrow from the Fund's newly-established Enhanced Structural Adjustment Facility. This is a most generous position for the Government to have taken--enlarging, as it does, the capacity of this facility to help smaller low-income countries. It is essential that it not result, in any way, in a reduction in concessional financing from other sources. India, which continues to face a formidable task of development, will require the strong support of the international community as well as persistent vigor in policies.

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Let me turn now to my main topic for the evening, the international monetary system. And allow me to begin with a few general observations--to put matters in some perspective.

First, we speak of a "system." This, though, is shorthand for what in reality is a complex amalgam of arrangements, involving institutions, policies, procedures and practices. It has even been suggested that we perhaps imbue such arrangements with more cohesion and predictability than is, in fact, their due. Be that as it may, the point to bear in mind is *that we are not speaking of a simple mechanism of interlocking parts, but* of an intricate network of arrangements. A network of arrangements, moreover, that, since the demise of the Bretton Woods system in the early 1970s, has allowed for a considerable measure of national policy discretion and thus become more complicated.

What do we look for from an international monetary system? What purpose ought it to serve? To my mind, it should above all facilitate the balanced growth of international trade and promote the efficient allocation of global resources, including world savings, under conditions of low and relatively stable inflation. I look for this because of its essential contribution to a full utilization of the productive resources of <u>all</u> countries--that is, to economic growth and improvement in social conditions worldwide.

That the arrangements in place in recent years have fallen short on this score has come increasingly to be recognized. And change is now under way. Change to what end? The task facing the international community is, I believe, in general terms well understood. It is to bring about some form of collective management of the monetary system that corresponds better than the current arrangements to the present level of international financial interdependence.

What is less clear at present are the precise contours of a better managed system. On this, two points are perhaps worth emphasizing. First, the preferred approach is unlikely to be the same for each and every country, and we are thus unlikely to have the luxury of a perfect convergence of views among nations. Indeed, it seems to me inevitable that any adaptation of present arrangements will reflect compromises among different objectives, different perceptions, and different degrees of willingness to engage in cooperative action.

But--and this is my second point--there seems to me to be no escaping the explicit acceptance of certain limits to national autonomy if the system is to function more effectively. What has yet to be determined is the degree of external discipline to which nations will submit and which will allow the system to operate smoothly. This is likely to become clear only gradually. Impatient though we all are to strengthen the existing arrangements, change is likely to be incremental and evolutionary. In contrast to 1944, it is more likely to emerge from developing patterns of cooperation than as the product of a particular international negotiation.

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This, I believe, is the framework in which, realistically, we are working. It is within this framework that I should now like to consider a number of concerns that have been voiced for many years by this country, among others. The concerns in question are neatly encapsulated in a statement made in 1973 by India's then Minister of Finance to the Committee of Twenty. This emphasized:

"... the need for an improved functioning of the adjustment mechanism in a framework of stable but adjustable exchange rates in a manner as would satisfy the aspirations of both developed and developing countries and which would also be equitable as between surplus and deficit countries alike"

and, in addition,

> "... better international management and control of global liquidity with the objective of moving towards a system in which special drawing rights would become the principal reserve asset as well as the numeraire."

Three issues: symmetry of adjustment; stability of the exchange rate system; and the role of the SDR. Fifteen years later, these matters are as pertinent as ever. Let us look at each in turn.

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First, symmetry. The quest for ensuring that all countries enjoy equivalent rights and observe equivalent obligations has been a major preoccupation of the framers of international monetary arrangements. Keynes, in his closing address to the delegates to Bretton Woods in July 1944, saw their task as having been "to find a common measure, a common standard, a common rule applicable to each and not irksome to any." Symmetry was likewise a dominant concern of the Committee of Twenty in its efforts, following the collapse of the par value system, to construct a new monetary order.

Yet the Bretton Woods system was perceived by many to have subjected surplus countries to weaker discipline than deficit countries, while also conferring a privilege on countries issuing reserve currencies by allowing them to finance payments deficits by incurring liabilities rather than drawing down assets. And, ambitious as its approach was, the Committee of Twenty was led to conclude that "there are practical limits to how far and how fast asymmetries in the system can be eliminated."

Today, various asymmetries are still perceived to exist. The one that I should like to focus on is the perceived asymmetry in adjustment responsibilities between different groups of countries--and specifically between countries that do not need to approach the IMF for financial assistance, on the one hand, and countries that do, on the other. That the forces operating on the first group to correct its imbalances are not as strong as those operating on the second group clearly continues to be true. The latter are real and pressing; the former are for the most part moral and persuasive. While the impact of appreciating currencies in surplus countries should not be lightly dismissed, flexible exchange rates have not sufficed to provide an adequate degree of symmetry. In this sense, the system has not evolved in the way Keynes wished it to evolve, having "an internal stabilizing mechanism, by which pressure is exercised on <u>any</u> country whose balance of payments ... is departing from equilibrium <u>in either direction</u>."

But I believe that progress has been made over the years, and particularly of late, in moderating the particular asymmetry in question. Progress has been made on both sides of the equation: in facilitating adjustment in heavily-indebted developing countries, easing its burden, and allowing it to be sought in a feasible time frame; and in injecting more bite into the advice given to industrial countries and bringing greater influence to bear on their policies.

As regards the former, consider the evolution of private capital markets. While the access of developing countries to these markets is uneven, while it is substantially less than it was in the 1970s, and while it cannot be compared remotely with that of the industrial countries, many more countries can borrow from such markets today than was the case twenty years ago. Consider also the evolution of the Fund's credit facilities. The compensatory financing facility and its various offshoots; the extended fund facility; the oil facilities; enlargement of the access of members to the Fund's resources. More recently, the structural adjustment facility and the enhanced structural adjustment facility; measures to increase the availability of credit under the EFF and to improve the terms of such credit; and the creation of a contingency financing mechanism. All have enhanced the opportunity for deficit countries to correct maladjustments in their balance of payments without resorting to measures destructive of national prosperity. So also have an expanded level of technical assistance and moral support. True, financing does not reduce the sum of adjustment that is required. But it does ease the burden of adjustment and helps to make adjustment more orderly by permitting it to be stretched out over time.

As regards the other side of the ledger--bringing influence to bear on countries that have no need to approach the Fund--the main tool at the Fund's disposal has always been the moral suasion that it exercises over members to follow policies that will further the economic prosperity of the entire membership. Here, three things have changed in recent years. First, the scope for exercising moral suasion has become much wider. The Fund's voice is heard not only on the occasion of annual consultations with its member countries, but also during twice-yearly reviews of the world economic outlook and through my participation, as Managing Director, in meetings of finance ministers and central bank governors of the major industrial countries--as well as through less formal channels of course. Second, the analytical substance of the Fund's surveillance over the policies of its member countries has become sharper, with symmetry in the adjustment process an important objective. In particular, in our bilateral and multilateral discussions with the major industrial countries, we make every effort to see to it that the interests of the rest of the world are taken into consideration. Third, the Fund is speaking out more--more often and with more candor.

All this, I believe, is injecting more weight into the surveillance process. But, clearly, more needs to be done if the responsibility for adjustment is to be shared more equitably and thus made more manageable. It is a historic challenge, to be sure. But it is vital that creditors not be allowed to remain passive; that effective surveillance be exercised over the policies of those countries with the most substantial spillover effects on the world economy; that efforts continue to achieve a system that members consider fair as well as efficient.

Traditionally, the international community--through the Fund--has made cautious use of sanctions or formal remedies, preferring to rely on persuasion and peer pressure rather than punitive action. Traditionally, the Fund has operated on the basis of guidelines, the interpretation and application of which have to a large extent been a function of the objective needs of the system itself. All this is surely right. But the question arises whether greater symmetry might not be achieved if it were possible to formulate more comprehensive principles than exist at present to guide the Fund in the exercise of surveillance. I believe that this is worth exploring. Not with a view to introducing mechanistic rules. But with a view to giving more precise shape to the expectations of the international community.

Countries in deficit could also help--by tackling their imbalances at an early stage. There are few better illustrations of the merits of this than India's experience in the early 1980s, to which I referred earlier. The imbalances in this country at that time were not great. But you confronted matters and sought the support of the Fund early. And adjustment was neither unmanageable nor antithetical to growth.

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Let me turn now to the second issue: stability.

The breakdown of the Bretton Woods system in the early 1970s ushered in a period of instability and improvisation that is still with us. The regime of generalized floating that emerged in its place failed to live up to expectations and in the event lacked discipline. What ensued were two things: a high degree of exchange rate volatility--manageable in the industrial economies, but troublesome to many developing countries who lack the institutional arrangements to cope with prolonged uncertainties in exchange markets; and, much worse, large misalignments of exchange rates over extended periods--misalignments which have resulted in substantial misallocation of resources, stoked the fires of protectionism, and helped give rise to external imbalances on a scale which threatens global growth and financial stability.

All this, not surprisingly, has given rise to some nostalgia for the old days. There is, though, a broad realization that a return to the Bretton Woods system is not feasible in a world in which capital movements are the prime determinants of exchange rates, and in which governments are no longer quite the dominant actors they once were in international financial markets. In any event, one should not exaggerate the discipline and stability that fixed exchange rates can bring. Instability is rooted in the shortcomings and inconsistencies of national economic policies. Fixing exchange rates, or setting tight target ranges, to my mind only raises questions as to how monetary and fiscal policies are to validate them.

Nor should one seek to suppress or reduce the role of the exchange rate. Changes in exchange rates have a time-honored place in the adjustment of payments imbalances. The world economy, moreover, will surely absorb the shocks it will inevitably encounter better--and with less cost--in the foreign exchange market than in markets such as the labor market.

What is needed, it seems to me, is a middle ground between excessive rigidity and excessive volatility and misalignments. This, in turn, requires two things: better management of national economic policies, in particular fiscal policy; and greater international coordination of such policies.

As concerns the former, there is a limit to which monetary policy can prudently substitute for changes in underlying fiscal positions and to which intervention can counter underlying market trends. Beyond a certain point, exchange market stability will hinge on the adequacy of underlying policies and on the determination of governments to stick to them.

As to the latter, in an increasingly interdependent world deliberate coordination is needed if the pitfalls associated with incompatible policies are to be avoided and if the potential for mutually consistent policies to achieve shared objectives is to be realized. Clearly, this will require some sacrifice of policy autonomy by sovereign nations. But cooperative action in an interdependent world is rarely a zero-sum game. At a minimum, it can forestall disruptive consequences and a general loss of welfare. At best, it creates the possibility of gains for all.

Over the past three years significant progress has been made by the major industrial countries in the direction of effective policy coordination. A forum for periodic discussions and a political mechanism for decision making have been established. Procedures to guide policymakers have been developed and are steadily being refined. These draw on a range of economic indicators to assess the international consistency, the desirability, and the sustainability of policies; to set objectives and monitor progress toward such objectives; and to heighten awareness of the implications of those policies and objectives for other countries, in particular developing countries. In all this it has been the task of the Fund to offer information, analysis and advice, to help bring the main issues to the surface more clearly, and--not least--to ensure the injection of a global perspective into the debate. As the Minister of Finance of the Federal Republic of Germany told the Fund's Annual Meeting, the Fund must continue to assist in this process not only with its analysis and advice, "but also because it represents the interests of the world economy as a whole."

A solid beginning has thus been made in moving toward not only a more stable system, but also a more symmetric system. In a speech a year ago to the Fund's Annual Meeting in Washington, the U.K. Chancellor of the Exchequer, Mr. Lawson, offered five reasons why the major industrial countries had been able to make the move to managed floating work. They had chosen the right time to give a lead to the markets. They had been prepared to commit themselves publicly to appropriate and consistent domestic policies. They had been prepared to give significant weight to exchange rates in the conduct of monetary policy. They had been prepared to undertake coordinated intervention, sometimes on a substantial scale--making such intervention, I might add, an accepted instrument in the emerging system. And they had neither revealed the details of their arrangements, nor worked within margins that were too tight to allow sufficient tactical room for maneuver.

While a promising departure has been made from the old ways, crises can still occur--as we saw only too vividly last October. Crises can also be managed, as we have seen since then. The point I would emphasize is that what has been achieved to date in fostering a more appropriate mix of policies among the major countries--encouraging as it is--is no more than a beginning. Debate continues on how to move the process forward and what the ultimate modus operandi should be.

That this is so--that the economic management system is still adapting to a situation of rapidly growing economic interdependence--should not come altogether as a surprise. Nations do have different priorities; they often hold different views on the effectiveness of particular policy instruments; and they have different perceptions of how economies interact. There are also obviously gaps in the understanding of some economic processes and, more so, limitations in the ability to foretell the future. These are what I would call "technical" obstacles to policy coordination. In addition, there are "political" obstacles. Even when there is agreement on the objectives and the "economics," there may well be difficulties in undoing arduously worked out domestic compromises, or in obtaining timely action where policymaking is decentralized and intermittent--as it typically is, for example, in the fiscal field. And there are, of course, perennial questions of burden sharing.

For all these reasons, it would be unrealistic to expect giant leaps forward in coordinated policy making. The process is inevitably an incremental one. The challenge is to continue to move it forward--to see that it does not stall.

What can be done to this end? I would suggest two things. First, press on with efforts to develop a framework of analysis that commands a broad basis of acceptance at the technical level and yet is straightforward and compelling enough to carry conviction at the political level. This is an area in which the Fund has a key role to play.

Second, continue to refine the instruments and procedures of coordination. It would, of course, serve no purpose to seek to be more precise than the present grasp of economics would permit, nor than the institutional and political constraint on fiscal policy would allow. But the more that understandings could be reached on key indicators, the more leverage could be created for prodding men of goodwill into remedial policy action when events in fact deviated from a desired course.

Only after further progress has been made in these two areas would there seem to me to be much point in the industrial countries exploring further refinements--such as introducing into their coordination process prescriptive elements which they would be under some obligation to try and fulfill.

It may never, of course, be possible to achieve total agreement among governments as to what policies are best pursued at any particular time. And it would be naive to expect to be able always to induce individual countries to alter their policies. But it should be possible to increase the mutual compatibility of national policies, to ensure that countries take the external effects of their policies more consistently into account, and thereby to improve the stability and efficiency of the system as a whole.

Over time, it should also be possible--notwithstanding the various difficulties I have just mentioned in advancing the coordination process among even a small number of countries--to involve countries outside the G-7 more meaningfully in the evolving process of international monetary cooperation. Not only possible, but to my mind essential. But it will take time. And the IMF, it seems to me, is the logical forum for bringing the rest of the world into what is, after all, a matter of common responsibility and universal concern.

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An international monetary system involves not only a set of exchange arrangements, but also provisions for the supply and management of international liquidity. This brings me to our third issue: the role of the SDR.

Special drawing rights were created with two basic purposes in mind: to meet the need, as and when it arises, for a supplement to existing reserve assets; and to serve eventually as the principal reserve asset of the international monetary system. In the period of almost twenty years since the SDR was launched, the equivalent of less than US$28 billion of special drawing rights have been created, and the SDR remains far from being a world money. It is used as a unit of account; it serves as a store of value to governments that hold them; and there are some privately issued SDR-denominated bonds and bank liabilities. But the SDR is not used as a medium of exchange.

Two realities, moreover, have to be recognized. First, the broad support needed among the Fund's membership to add to the stock of SDRs through a new allocation does not exist at the present time. Second, for the SDR to become the principal reserve asset of the international monetary system, profound changes would have to be made in that system--changes which, although well worth serious consideration, would inevitably take time.

In the meantime, the question remains whether the SDR cannot play a more important role than it is now doing. Decisions on new allocations of SDRs, of course, turn on an assessment by the Fund's membership of whether there exists a long-term global need to supplement existing reserves. However, judgment must be exercised in making this assessment, including judgment about the quality of reserves and the purposes they should serve. In this context, various issues arise bearing on the question of an allocation of SDRs that did not arise formerly.

Could an allocation, for example, help to provide a liquidity safety net? With borrowed reserves now much more important than they used to be, the adequacy of international reserves has become more vulnerable both to instability in financial markets and to shifts in market confidence in individual countries.

Could it facilitate the financing of coordinated exchange market intervention, strengthening the ability of governments to counter any sudden disruption of markets by speculative forces? Already, with the latter objective in mind, we have seen the United States and Japan enter into a bilateral agreement that would make <u>existing</u> SDRs more readily available to exchange for other currencies.

Could it usefully reduce the high cost for many countries of generating reserves through further adjustment of their current accounts? I am mindful here of the broad withdrawal of commercial banks from voluntary lending to many developing countries. This represents a structural change in international financial arrangements which makes it appreciably more difficult for the countries affected to meet their growing need for reserves.

By serving these various ends, could a new allocation of SDRs improve the functioning and stability of the international monetary system? It is a matter that in my view deserves further thought.

More generally, we need to ensure that the SDR is not allowed to atrophy. We need to make it more attractive to use and hold. And we need to put the role it could play on the agenda of our reconsideration of the monetary system as a whole. I am pleased that in Berlin we were encouraged by a number of speakers to give further thought to these matters.

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Ladies and gentlemen, it will be clear from what I have said this evening that our agenda is an extensive one. And it is, of course, one that falls centrally within the domain of the Fund, which was brought into being precisely to provide "the" machinery for consultation and collaboration on international monetary problems.

In tackling this agenda and looking to the future, we are fortunate to be able also to draw from the past. The major contribution of the Bretton Woods system was its recognition that international money could not manage itself and needed an element of consultation and cooperation, if not supervision, for order to be maintained. That reality has never been more valid than it is today. But there was also another element in the spirit and vision of those who, like C. D. Deshmukh, were "present at the creation." And that was the need to shape practices and policies in such a way that the varying needs of a diverse membership were adequately met. That, too, remains fundamental.