Comment on "Reforming the International Monetary System," by Peter B. Kenen

Percy S. Mistry

Reminding us, as John Williamson did last year, that any reform of the International Monetary System (IMS) at the present time is best aimed at being modest rather than ambitious, (for the same depressingly familiar reasons), Peter Kenen uses his introduction to set the stage for reviving proposals which are incremental and, for that reason, offered as more acceptable. The pragmatic flavour of the diagnosis can hardly be argued with: but one wonders whether such fatalistic acceptance of minimalism in the name of pragmatism, may not lead to self-fulfilling prophecies where outcomes are concerned. It is now fashionable, especially among the battle-weary, to believe that, in the face of acute introversion coupled with extraordinary inaptitude and progressive paralysis on the part of a particularly sorry crop of G-7 governments, there is no prospect of reforming the IMS in the way that substantially changed global circumstances demand.

I find it intriguing that in the same breath with which we lament the incongruity of relying on the vestigial institutional framework of an IMS originally designed in the 1940s to cope with the realities of the 1990s, we make ourselves believe that there is no point in being too bold about the design or agenda for reform.[1] In doing so I wonder if we are not diminishing prospects for the kind of reform that is indeed needed in the IMS. In pointing out that anomaly I do not argue in favour of reviving the 1970s fashion of tilting at policy windmills – even though the wide ties and bell-bottomed trousers characteristic of that era appear to be in vogue again! But is it completely out of the question to exert sustained intellectual pressure on G-7 governments to have them treat the IMS as something more than a vehicle for achieving expedient short-run political objectives each time a crisis occurs?

That said, three important points are embodied in what Kenen says which should not get lost during our deliberations on the IMS:

1 Clearly the situation is not quite as bad as that. The IMS has been modified in bits and pieces (invariably on a too little too late basis) using jerry-built structures since the breakdown of the Bretton Woods Arrangement in 1971.

From: The Pursuit of Refonn: Global Finance and the Developing Countries
FONDAD, The Hague, 1993, www.fondad.org

- developing countries have a major stake in strengthening the multilateral trading system through GATT (although the unexplicated corollary to that assertion is that they are unlikely to benefit as much as they might without essential reforms in the IMS);
- the G-7 countries are prone to "innovate and improvise when it suits their purposes" even incurring the risk of damaging the IMS as they appear to have done most recently with their twisting the IMF (and World Bank) out of shape to cope with the problem of Russia;
- there remains an awkward asymmetry after the excesses of the 1980s in letting monetary policy in the G-7 countries bear too much of the brunt of domestic adjustment to self-inflicted damage with profound implications for exacerbating the malfunctioning of the IMS. Unwillingness in the post-Reagan-Thatcher era to bring fiscal policy sufficiently into play has had significant consequences. For example Germany's choices in financing the higher than anticipated costs of unification have destabilised the EMS and forced much higher costs on its EC neighbours (and on the rest of the world) than were strictly necessary. The costs incurred by the U.S. and U.K. in making similar choices to avoid the political pain of corrective fiscal policy have also had significant domestic and international implications.

These choices, of course, circumscribe the room for manoeuvre open to developing countries in adjusting involuntarily to global shocks induced by the G-7's domestic policy failures (as opposed to those caused by market cycles influencing the supply, demand and price of tradables). Developing countries have even less influence over such shocks than over market-induced ones. The present IMS fails to cushion those shocks as it is ostensibly supposed to. Worse still, the system occasionally behaves in ways that exacerbate their effects (as in the case of the debt crisis). Part of the case for reform of the IMS rests on the need to rectify those two shortcomings. The other arguments for reform concern the issues raised by Kenen (and earlier by Williamson), i.e. the need for an IMS which:

1. enables the provision of sufficient liquidity through reserves and access to reserve credit (reserve substitutes) to underpin the stability (and credibility) of exchange regimes and permit the steady expansion of world trade and growth; and,
2. facilitates the flow of investment finance in the "right" direction without incurring the risk of repeated market failure (of the kind that last occurred in the 1980s) based on the cumulative effects of misperceived investor/lender expectations, herd instincts, unregulated (and uninformed) competition within the system and imperfect information.

The paper's discussion on reserves in an environment of increasingly mobile capital flows and the availability of reserve credit is instructive. It takes the

Williamson argument [2] about the "creditworthiness constraint" a step further, with useful observations about why: (i) reserve credit is not a perfect substitute for reserves, and (ii) the use of such credit under stress involves less flexibility and higher costs than the use of owned reserves.

Drawing the obvious links between the need for reserves with that of access to international capital markets, Kenen examines patterns of resumed capital flows to developing countries claiming good news in "several" developing countries of Latin America and Asia (I am sure he means East Asia when he refers to South Asia) most of which have increased their reserves as a result. He underlines the importance of countries benefiting from such flows striking a careful balance between importing real resources, accumulating reserves and avoiding the monetisation of reserve accumulation, pointing out the difficulties that some developing countries face in sterilising reserves because of the limitations of their internal capital markets. Consequently they are confronted with the "unpleasant options" of non-accumulation of reserves, exchange rate appreciation or monetisation and money-supply led inflation.

The paper highlights the increase in reserves of developing countries between 1989-92, including those of low-income African countries although many of these still had absolute levels of reserves (relative to imports) which were low. Using this evidence, Kenen concludes that it is hard to make the case that there is now an acute shortage of reserves or that reserves are globally maldistributed. That overstretched conclusion does not appear supportable on the basis of the evidence Kenen presents. Though the reserves position may be marginally better (especially for Africa) than it was through most of the 1980s it is hardly comfortable in any sense.

Rather than an SDR emission to increase reserves Kenen prefers to argue for making reserve credit more readily available to developing countries through two specific reforms:

- increasing access to the Compensatory and Contingency Financing Facility (CCFF) of the IMF by dropping conditionality requirements; and,
- encouraging countries enjoying large capital inflows to accumulate reserves by matching their increases with increased (supplementary) access to reserve credit beyond their normal drawing rights and employing a form of "shadow conditionality", the precise exercising of which is outlined in some detail.

The paper's abrupt end with those proposals leaves one not so much with a sense of an unfinished meal but of being served with only half the *hors*

2 "International Monetary Reform & The Prospects for Development", J. Williamson. In: "Fragile Finance: Rethinking the International Monetary System", edited by J.J. Teunissen, FONDAD, 1992.

d'oeuvres coupled with a vague notion of internal contradictions in Kenen's own arguments. To dispose of the latter issue first, I was struck by the contradiction between paper's earlier arguments about the costs and loss of flexibility in using reserve credit (as opposed to own reserves) and both its suggestions leaning in favour of increasing access to reserve credit rather than towards simply increasing own reserves (e.g. through an SDR emission). Secondly, I found it odd that there were no suggestions in favour of creating innovative synthetic instruments (either capital markets or special deposits held with the IMF or Multilateral Development Banks) which would enable countries without much "sterilisation capacity", because of domestic capital market conditions, to enhance such capacity and minimise the other less pleasant consequences of reserves accumulation.

But of far greater concern to me (this was the same difficulty I had with the Williamson paper last year) was the absence of a sufficiently clear idea of:

- What exactly it was about the IMS today that Kenen saw as being deficient insofar as the developing countries were concerned and how his two suggestions addressed those deficiencies. If, as he seems to contend there is no acute shortage of reserves why focus on measures to increase access to reserve substitutes?
- What in Kenen's experienced view might constitute a comprehensive agenda broken up realistically into short, medium and long-term measures to correct those deficiencies? Assuming his two (sensible) but in my view not terribly powerful suggestions were implemented quickly what would he follow these up with? Or would he rest content with just those changes for a while?
- What should be done to implement a more comprehensive reform agenda in a phased evolutionary manner which would address sensitively and responsively the political difficulties and obstacles imposed by the major countries to such reforms? Or is that irrelevant because the times do not permit the luxury of such thought?

Deficiencies in the IMS (seen from the viewpoint of developing countries) were implied by allusions to previous tired arguments from the 1970s (about the SDR-Aid Link, etc.) rather than explicated from a fresh and clear perspective of what it was about the IMS in the 1990s that failed to meet the legitimate need (not the previous wilder demands) of developing countries; taking into account of course that the circumstances of developing countries have changed dramatically in the last two decades.

An approach to the development of a comprehensive, coherent agenda was finessed by an appeal to recognising the realities of present political circumstances in G-7 countries and the implied impossibility of getting attention focused on any worthwhile set of wider reforms.

From: The Pursuit of Refonn: Global Finance and the Developing Countries
FONDAD, The Hague, 1993, www.fondad.org

It is often assumed that the deficiencies of the IMS are too obvious to require articulation. That may be true for the cognoscenti. It is patently untrue in the case of government officials and policymakers who influence decisions about the IMF's functioning. I believe therefore that it is essential for a powerful set of arguments to be developed from first principles by respected authorities, based on widely understood and consensually agreed notions about exactly what is wrong with the present IMS in meeting the needs of developing countries.

Second, it is essential to draw the link between why developing countries are unlikely to benefit fully from a strengthened multilateral trading system or from market-friendly structural adjustment unless the IMS is reformed to cope with its more glaring deficiencies.

Third, it is essential to understand much more clearly how significant departures by the OECD countries from an adherence to market principles in key global markets affect the trading positions of the developing countries and whether they create special pressures which the IMS must attempt to relieve in acceptable ways. These departures are invariably made to suit the domestic political circumstances and convenience of the OECD countries (and their private sectors and labour unions). They affect global markets for labour, agricultural products, minerals, services, and a variety of manufactures in which developing countries have now established a strong competitive position (e.g. textiles, consumer electronics, etc.)

Fourth, it is essential to understand much better than we do now, the vulnerability of developing countries to external shocks resulting from the policy failure of major OECD countries, rather than from market failures, and to examine how well the IMS functions in insulating these shocks or in helping the victims cope with post-shock traumas.

Apart from developing arguments for reforming the IMS around these four building blocks, it is perhaps time to recognise that discussions of the IMS with reference to developing countries *en bloc* are becoming increasingly meaningless. It is of course a commonplace to assert that developing countries are a far less homogeneous group than they were when the progenitor of the present IMS was first designed in 1945 or even from when Bretton Woods broke down in 1971 only to be held together by string and cellotape thereafter. Yet it should be obvious that the reserve requirements, liquidity needs and investment financing needs of small and large economies in East Asia, South Asia, Central Asia, South America, Central America and the Caribbean, North Africa, sub-Saharan Africa, the Middle East, Eastern & Central Europe and the former Soviet Union (FSU) are as different as chalk and cheese. One might argue that even regional distinctions are too aggregate to be meaningful although it seems to me that it may well be possible to generalise meaningfully at the regional level.

From: The Pursuit of Refonn: Global Finance and the Developing Countries
FONDAD, The Hague, 1993, www.fondad.org

Taking the argument further, as intra-regional trading blocs are becoming more a reality, is there not a case for considering some transformation of the IMS to be more flexible and responsive to regional liquidity and investment interests using regional resources?

Would it not, for example, be sensible to consider African liquidity and reserve requirements (as well as exchange rate policy and the trading regime) in the context of facilitating greater intraregional trade and continental integration, especially with the emergence of post-apartheid South Africa, rather than in terms of relationships with the rest of the world – a situation which has worked to Africa's increasing disadvantage as it becomes more marginal in the global trading system?

Should we not be thinking of more imaginative arrangements and a different nexus between the IMF (or regional mini-IMFs) and the regional development banks in backstopping regional liquidity arrangements and investment flows than we have been inclined to do so far?

Part of our problem in thinking about reforming the IMS seems to be that we are trapped by being at the wrong starting point, i.e. we think about reforming the IMS from the stale view of the institutional (and instrumentation) framework we have inherited from a now defunct Bretton Woods arrangement rather than from the fresher viewpoint of global and developing country needs. In other words, our approach to reform is supply-side rather than demand-need driven.

At a global level should we attempt to define clearer roles for the IMF and the World Bank in the IMS instead of having their roles being driven by events such as the oil-shock in the 1970s, the debt and adjustment shocks of the 1980s and the "unipolarisation" shock of the 1990s?

Finally, international finance is now dominated by the private financial system in which officially directed flows of finance are insignificant. Ought we not to be thinking about a new and different nexus between the official and private segments of the IMS not simply in catering more responsively to developing countries but to the need of the world as a whole?

The privilege of being a commentator rather than an author is that one can indulge in asking the big questions while being relieved of the responsibility of providing the big answers. Peter Kenen is far more accomplished *artiste* in the latter department than I am ever likely to be. So I shall stop here without pushing my luck further, leaving him with the thought that we await bolder and more colourful strokes of his brush across a wider canvas than he has chosen for this particular paper.

From: The Pursuit of Refonn: Global Finance and the Developing Countries
FONDAD, The Hague, 1993, www.fondad.org