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DEVELOPMENT AND INTERNATIONAL ECONOMIC CO-OPERATION

The current international monetary situation

Report of the Secretary-General

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I. INTRODUCTION

1. The present report is submitted in response to General Assembly decision 41/442 of 5 December 1986, by which the Assembly requested the Secretary-General "to prepare a report on the current international monetary situation, taking into account recent discussions and developments on the matter ... and, in this regard, to provide information on proposals that had been made in recent years by Governments, prominent persons and organizations for convening an international conference on money issues".

2. The report starts by identifying some of the functions and desirable characteristics of the international monetary system and briefly describing some key problem areas in the present international economy. In the latter half of the 1980s, economic adjustment stands out as the dominant policy priority: adjustment is needed to remove the imbalances between the major economic Powers and to restore economic growth in the developing countries. In the two main sections of the report, the role of the international monetary system in facilitating these adjustments is examined. Proposals for the convening of an international conference on monetary and financial issues are summarized in the annex to the report.

3. Two other reports of the Secretary-General that are before the General Assembly at its forty-second session - on the international debt situation in mid-1987 (A/42/523) and on the net transfer of resources from developing to developed countries (A/42/272-E/1987/72) - complement the present report. Chapter IV of the World Economic Survey 1987, 1/ chapter V of the World Economic Survey 1986 2/ and two earlier reports, entitled "International monetary reform and the socialist countries" and "The changing institutional character of international financial markets in the 1980s", 3/ provide further background information. In addition, the issues addressed in the present report are examined at greater length in various reports prepared by the secretariat of the United Nations Conference on Trade and Development (UNCTAD). 4/ The present report is not intended to extend the analysis described in these earlier documents; rather, one of its purposes is to emphasize the continued importance of their conclusions in the context of the present international adjustment process.

II. THE INTERNATIONAL MONETARY SYSTEM IN THE LATTER HALF OF THE 1980s

4. The objective of international monetary consultation and co-operation is to provide favourable conditions for international trade and investment. Present arrangements have been subjected to considerable criticism in recent years. For some time, developing countries have argued, through the Intergovernmental Group of 24 on International Monetary Affairs (Group of 24) and other channels, that the present system operates in a way that does not adequately take their problems into account. More recently, the large swings in exchange rates of key currencies and the persistence of the trade imbalances among the major trading countries of the world have given rise to much questioning and criticism of the present system in developed countries as well. Calls for a reconsideration of the international

monetary system, albeit on different premises and for different reasons, have thus been made from many sides. Some of the suggestions for a new international monetary conference are identified in the annex.

5. The international monetary situation encompasses a broad variety of circumstances and issues. Some of them, such as the monetary relations of members of the Council for Mutual Economic Assistance with the rest of the world, will not be dealt with in the present report. Attention will be focused on the performance of the monetary system as defined by international monetary arrangements among members of the International Monetary Fund (IMF).

6. International monetary arrangements are aimed at reconciling the policies of sovereign Governments in areas where their economic interests may conflict very profoundly. Exchange rates are the first and most obvious issue: their determination is by definition a matter of long-term mutual interest. It is not obvious, however, whether a particular country's interest is in an under-valued exchange rate, with its attendant problems of excess demand for imports, or in an over-valued exchange rate, with its negative effects on domestic output and employment. A second issue relates to the adjustment process for remedying disequilibria in the international balance of payments. Efforts by one country to correct an external imbalance will inevitably have repercussions for its partner countries. Under the present system, it is usually deficit countries that are required to initiate adjustment; the external consequences of such action will tend to be a reduction in the level of demand and output in trading partner countries.

7. The international monetary system is expected to accommodate these potentially conflicting objectives of national Governments. In the language of the articles of agreement of IMF, the system should "shorten the duration and lessen the degree of disequilibrium in international balance of payments" and provide countries "with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity". 5/

8. The perceived shortcomings of the system in fulfilling these requirements and the proposals for remedying them change with economic circumstances, but they usually relate to three broad topics: the functioning of the exchange rate system; the availability of international liquidity, particularly international reserves; and the role of the international financial institutions, notably IMF. There have been changes in all these aspects of the system over the years, but they have not kept pace with the concurrent and rapid structural changes in international economic relationships and financial markets. In order to assess the adequacy of present arrangements, it is necessary to examine the broad requirements of the international monetary system in the context of the current world economic environment and in the light of developments in world financial markets.

9. One objective of a well functioning international monetary system is that it should facilitate international adjustment to eliminate fundamental disequilibria between and within countries as rapidly and with as little disruption in the level of economic activity as possible. During the adjustment process, countries need international reserves and liquidity in order to gain time and thereby to avoid unnecessarily large short-term adverse effects on their levels of domestic

activity. A primary purpose of the international monetary system is to provide these reserves and the necessary supplemental liquidity. The system should provide for growth of international reserves that is commensurate with the expanding, though for many countries increasingly unstable, volume of trade flows and the unpredictable pattern of international financial transactions. It should also ensure that all countries have access to international liquidity to provide them with the financial flexibility necessary both to make adjustments in their economies and to absorb short-term shocks. The system also needs to incorporate a system of exchange rates between currencies that contributes positively to any necessary adjustment and that does not act as a disruptive influence on either domestic economic activity or international economic relations. Last but not least, the system needs to be such that it instils confidence in participants that these tasks can be performed in a satisfactory manner.

10. The functioning of the international monetary system and confidence in it would be enhanced if there were some unambiguous and universally accepted "rules of the game" as to how its tasks should be accomplished. A comprehensive set of such rules is lacking in the present system. The system itself does not necessarily ensure the disappearance of underlying disequilibria in international payments and does not provide participants with "rules", sanctions or incentives that would facilitate a speedy return to a position that is sustainable in the long term. As a result, adjustment does not necessarily take place in a way that is conducive to the growth of world output and employment and is to the benefit of all parties. In particular, the system is not symmetrical in its treatment of countries that accumulate large surpluses in their current account and those which have large deficits.

11. These shortcomings of the system are brought into focus by the failure to remedy the imbalances between the developed market economies and the imbalances of countries with debt-related difficulties. These problems began to surface in the late 1960s, but became particularly apparent in the early 1980s; some five years later, far from having corrected themselves, they have worsened and seem likely to prevail into the 1990s. The most obvious consequence has been the mediocre performance of the world economy in this period.

12. In the developed market economies, disequilibria persist in the form of stubbornly high unemployment in many countries and unprecedented trade imbalances among the three largest countries in the group. There have also been prolonged misalignments of the exchange rates among the major currencies, and real interest rates, after having briefly climbed to unprecedented levels, remain high and have acted as a deterrent to accelerated growth.

13. These imbalances cannot continue indefinitely without a further slowing of economic growth. The concern is that, if the gaps in the external account come to exceed the willingness to finance them, they will result in sudden and disruptive changes in international financial variables. Climbing interest rates and protectionist pressures are signs of this threat.

14. In developing countries, balance of payments and other difficulties resulting from international indebtedness have become more widespread. As discussed

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elsewhere (A/42/272-E/1987/72), there is currently a net transfer of resources from these countries as a group amounting to about $24 billion per annum, 6/ adversely affecting their economic growth.

15. In many developing countries, the underlying external disequilibrium has been suppressed and a semblance of balance has been restored by forcible adjustment of real or financial variables. Debts have been rescheduled (or, in some cases, payments unilaterally suspended); imports have been curtailed; domestic expenditure, particularly investment, has been reduced; and exchange rates have been adjusted.

16. A number of centrally planned economies have also encountered external payments problems. These were overcome in 1982-1984 through methods that in their effect were similar to the adjustment efforts of market economies. Recently, the underlying disequilibria have manifested themselves in a reappearance of current account deficits in a number of centrally planned economies. 7/ In both developing and centrally planned economies, import restrictions may have produced an approximation to external balance in the short run, but they have disguised the long-run dimensions of the problem.

17. The external environment to which smaller countries are adjusting is itself not in equilibrium as long as the imbalances between the major industrial countries remain unresolved. One result is that many of the developing countries and countries with centrally planned economies that have already undergone several years of adjustment have neither regained economic momentum nor restored their credit-worthiness in international financial markets.

III. ADJUSTMENT IN THE DEVELOPED MARKET ECONOMIES: CAPITAL FLOWS, FLOATING EXCHANGE RATES AND POLICY CO-ORDINATION

18. One of the challenges currently facing the international monetary system is the correction of the persistent current account deficit of the United States of America and the surpluses of the Federal Republic of Germany and Japan. These imbalances remain largely unchecked because the United States has been able to attract from the rest of the world capital inflows large enough to finance both its fiscal deficit and the shortfall in domestic savings. Net capital flows from Japan to the United States increased steadily from $8.3 billion in 1980 to $53.4 billion in 1986; net flows to the United States from States members of the European Economic Community, a large share of which is accounted for by the Federal Republic of Germany, changed from -$8.4 billion in 1980 to $26 billion in 1986. 8/

19. In the early 1980s, the magnitude of this demand for dollar-denominated assets was such that it caused the dollar to appreciate, which exacerbated the United States trade deficit. However, in early 1985, market forces reflected the recognition that the current account deficit of the United States was unlikely to be sustainable over the longer term and the dollar began to depreciate. The Plaza Accord of September 1985 set in motion a number of co-ordinated policy actions in the leading market economies designed to ensure that the depreciation took place in an orderly fashion. Two years later, after a major realignment of currency values

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and some supportive foreign and domestic measures, the major external imbalances are only beginning to show signs of improvement.

A. The role of floating exchange rates

20. When the system of fixed exchange rates was abandoned at the beginning of the 1970s, it was argued that floating exchange rates would facilitate the international adjustment process because they would move towards long-run equilibrium values and thereby bring about long-run balance in countries' external payments and receipts. In the short term, movements in exchange rates were expected to absorb external shocks and give countries greater autonomy in their economic policy.

21. Floating exchange rates have weathered a period of substantial shocks and institutional changes in the world economy. Currency convertibility has been maintained and there have been no generalized restrictions on trade or capital flows. Financial deregulation and a movement towards greater capital mobility have been possible with floating rates; the developed market economy countries have also been able to pursue strongly disinflationary policies with relative ease.

22. Despite those strengths, some 15 years of experience with floating exchange rates have shown that the system also has serious shortcomings. Contrary to expectations, exchange rates have not consistently moved towards their long-run equilibrium values - values that are consistent with sustainable long-term trends in both the current account and the capital account. There is broad agreement that there have been extended periods in the 1980s when the exchange rates between some of the major currencies have been misaligned, that is, they have not reflected accurately the relationship between the underlying economic characteristics and circumstances of the countries concerned. As noted by the Group of 10, there have been "large medium-term movements in real exchange rates". 9/ The amplitude of exchange rate fluctuation has arguably been greater than would be expected if the market were simply in the process of moving towards a long-term equilibrium.

23. Another characteristic of the floating exchange rate system has been the volatility of the short-term fluctuations in rates. Regardless of the measure used, short-run volatility has been significantly higher than under the Bretton Woods system. One study suggests that volatility in nominal exchange rates has been six times greater, and volatility in real rates three times greater, than with fixed rates. 10/

24. The volatility of exchange rates in the short term cannot be explained by fundamental economic variables. On occasion, even the direction of change is not supported by the underlying economic conditions in the countries concerned. As a result, there has been a high degree of uncertainty about future exchange rates.

25. According to the Group of 10, "exchange rate instability has been fuelled by inadequate and inconsistent policies that have led to divergent economic performance". 11/ The floating exchange rate system has no built-in mechanism that will quickly remedy inconsistencies such as a tight monetary policy

accompanied by an expansionary fiscal policy; exchange rates are more likely to adjust to, and reflect the relationship between, countries' economic policies. For example, in the absence of any compensating changes in other countries, a tightening of monetary policy through increased interest rates is likely to cause an appreciation of the domestic currency. Inconsistent policies within the major industrial countries and a lack of co-ordination among them, particularly in fiscal policy, have been major sources of both the short-run volatility and longer-term misalignments of exchange rates since the early 1980s. 12/

26. Misalignment and increased volatility have also arisen because of currency speculation, which itself has been facilitated by the growth of international capital markets. Speculation is likely to intensify whe the market expects a currency to become more over-valued (or under-valued). A profit can be made by purchasing the over-valued currency and selling it later, before the over-valuation corrects itself. This tends to increase the extent of misalignment until the currency finally and unexpectedly crashes in the direction of its correct value. Speculation, and consequently misalignment, is also likely if government policy is not credible: speculation against the government's policy may become self-fulfilling if it gathers sufficient momentum.

27. Speculative and other long-term and short-term capital flows have become a more important determinant of exchange rates than relative purchasing power and trade conditions; they have also surpassed any levels that were considered possible at the time that the floating rate system came into being. Their magnitude is another factor that has compromised the ability of Governments to influence exchange rates and therefore contributed to the short-run volatility in rates.

28. If they are to play a major role in international adjustment, exchange rates should serve as fundamental guides to resource allocation within an economy and between one country and the rest of the world. Persistent misalignments among the major currencies prevent exchange rates from fulfilling this function and can have widespread adverse consequences, summarized by one author as "massive payments imbalances, consequential international investment flows that bear no relationship to the real scarcity of capital, distortions to the optimal time pattern of consumption, unnecessary adjustment costs as resources are shifted back and forth between the tradeable and non-tradeable sectors, the destruction of productive capacity, possible ratchet effects on inflation and protectionist pressures". 13/

29. The negative effects of misalignment on investment are of particular concern because of the consequences for longer-term growth. A misaligned exchange rate may make some investments unprofitable in the world market, causing them to be abandoned and raising the perceived risks of future investments. This effect of misalignment may be worsened if the overhead costs of re-establishing a presence in that market are large enough to discourage re-entry, even in the event that the real exchange rate returns to its initial level. Additional real depreciation might then be needed to coax firms back and to restore trade flows to their previous pattern. 14/

30. This suggests that the increased uncertainty produced by the floating rate system has a negative influence on the level of world trade. On the other

hand, the use of financial instruments such as forward cover, futures and options can reduce the risk in foreign exchange transactions (although each involves a cost that is directly related to the variability of exchange rates). The empirical evidence concerning the effect of exchange rate volatility on the volume of trade is not clear-cut. 15/ One of the more recent of several studies on this question shows that the increase in the variability of real exchange rates has been a significant factor in explaining the slow-down in international trade since 1973, but that the decrease in the rate of growth of output and the slow-down in economic integration among the industrial countries have been more important. 16/

31. According to the Group of 10, "the adoption of sound, credible and stable policies in all countries, especially the major ones, can contribute fundamentally to exchange rate stability". 17/ In an increasingly interdependent world, this requires co-ordination of economic policies. Floating rates have not been accompanied by the degree of policy co-ordination necessary for a well functioning international monetary system.

B. Target zones, co-ordination and surveillance: the elements of a more viable exchange rate system

32. There is general agreement that the previous system of fixed exchange rates was too rigid, while the present system of floating rates is excessively volatile. An exchange rate system based on "target zones" 18/ is one possible alternative arrangement. The Group of 10 defines target zones for the exchange rates of major currencies as "wide margins around an adjustable set of exchange rates devised to be consistent with a sustainable pattern of balance of payments". 19/ Target zones require estimates of real equilibrium exchange rates and can be cast in various forms depending on the width of the margins, the frequency of realignments, the degree of publicity given to the zones ("loud" versus "quiet" zones) and the degree of commitment to staying within the margins ("hard" versus "soft" zones).

33. The European Monetary System is a target zone arrangement that uses nominal exchange rates organized around a composite currency, the European currency unit (ECU). The System is a "hard" and "loud" target zone arrangement that imposes a strict commitment on members to intervene to keep bilateral rates within established margins. It attempts to preserve stability in nominal exchange rates, not real exchange rates, with the result that members may experience relative price movements without realigning rates. Moreover, the System provides for the realignment of nominal bilateral rates in the event of "fundamental disequilibrium". There were only 12 such realignments between the introduction of the System in 1979 and the middle of 1987, even though there were a number of major disturbances in the global economy during that period.

34. A number of studies using different measures of exchange rates and different frequencies of data point to a significant reduction in the short-term volatility of exchange rates within the System, in both nominal and real terms. 20/ This trend towards greater stability was strengthened after 1982 and is in contrast with the behaviour of exchange rates outside the System.

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35. Supporters of the target zone proposal claim that it would improve macro-economic co-operation since exchange rates would have to be mutually consistent to be sustainable. Such a scheme would increase discipline in the monetary system by strengthening peer pressure when the basic cross exchange rates were negotiated. It would also reduce the asymmetry in international adjustment because large economies would be subject to the same external constraint as smaller ones. 21/

36. A major difficulty of target zones would be that of determining, and reaching agreement on, long-run equilibrium exchange rates. This difficulty would be particularly pronounced at a time, such as the present, when the monetary system, especially exchange rates, was in disarray. Having established target rates, the system would not be viable without substantially improved macro-economic co-ordination. Serious divergences in fiscal policies would be incompatible with target zones in the medium term, while rigid adherence to the zones might cause large fluctuations in relative price levels. It follows that a system of target zones would not be sufficient in and of itself to ensure an improvement in the functioning of the exchange rate system: supportive arrangements would be indispensable.

37. A mechanism that could bring about enhanced co-ordination of domestic economic policies among the major industrial countries was proposed by the Group of 24 in 1985. It "would involve multilateral discussions and negotiations to be conducted on a regular basis within the framework of the IMF about a mutually consistent set of objectives, and a set of policies to collectively achieve those objectives. The aim might be to search for a set of outcomes or 'objective indicators' or 'targets' that appear to be sustainable in the medium term and desirable to all parties ... The second stage would involve a comparison between the actual outcomes of the recommended targets or indicators, and a discussion of what measures would be appropriate when the two deviate". 22/

38. Some progress has been made in improving the co-ordination of macro-economic policy. A first step was the Plaza Accord of September 1985, in which the five leading economic Powers agreed to concerted action to ensure a controlled fall in the value of the United States dollar. At the Tokyo Summit in 1986, the Group of Seven industrial countries agreed in principle on the use of indicators, while at the Economic Summit held at Venice in June 1987, the statement by the Group of Seven included the following:

> "The co-ordination of economic policies is an ongoing process which will evolve and become more effective over time. The Heads of State or Government endorse the understandings reached by the Group of Seven Finance Ministers to strengthen, with the assistance of the International Monetary Fund (IMF), the surveillance of their economies using economic indicators, including exchange rates, in particular by:
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> "(a) The commitment by each country to develop medium-term objectives and projections for its economy, and for the group to develop objectives and projections that are mutually consistent both individually and collectively;

"(b) The use of performance indicators to review and assess current economic trends and to determine whether there are significant deviations from an intended course that require consideration of remedial actions." (A/42/344, annex, para. 11)

39. The Finance Ministers reached agreement on six objective indicators (growth of output, trade, budget balances, inflation, interest rates and exchange rates), which they would use to monitor the performance of their economies. The fact that the exchange rate is included among the indicators implicitly means that some form of target zone for current exchange rates will be used and that there will also have to be a medium-term view regarding the evolution of exchange rates. However, the indicator framework extends beyond exchange rates and will place correspondingly greater demands on Governments. In particular, the use of budget balances and interest rates as objective indicators should help remove the major underlying cause of the misalignment of exchange rates, namely inconsistent and sometimes unsound domestic policies.

40. The objective indicator framework is a significant step towards facilitating an institutionalizing macro-economic co-ordination, but it falls short of the proposal made by the Group of 24 in two important respects. First, the consultations will be among only the industrialized countries and not in a more encompassing framework, such as IMF. The Group of Seven agreed to strengthen the surveillance of their economies with the assistance of IMF and to monitor economic developments in co-operation with its Managing Director. Wider participation in this process seems desirable.

41. A second shortcoming of the agreement among the major industrial countries is that it does not include any explicit understanding on the measures that will be adopted if the indicator targets are not met. There is agreement to consult on such divergences, but experience suggests that this may not be sufficient to ensure that corrective action is taken. A wide variety of sanctions is possible. One proposal regarding external balances is to penalize reserve currency countries when their current account surplus or deficit exceeds a certain proportion of their gross domestic product (e.g., 2 or 3 per cent) for more than two years. The penalty might consist of an interest-free loan to IMF proportionate to the "excess" surplus or deficit. IMF could use these resources to provide subsidized stand-by arrangements for growth-oriented adjustment in lower-income countries.

42. The present ad hoc agreements to improve economic co-operation and surveillance among the leading market economies represent an important first step in overcoming some of the disorder that has prevailed in foreign exchange markets in recent years. The earlier agreements among the Group have already yielded results in a relatively orderly major realignment of the exchange rates between the major currencies. However, according to one international organization,

"The initiative towards better policy coordination that was launched at the Tokyo Summit, taking elements already contained in the Plaza Agreement, is still in the process of being followed up. While it makes sense to create a new framework in which to pursue policy coordination with a medium and long term view, there is hesitancy on all sides when it comes to making commitments

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with implications that are difficult to foresee. In the absence of such a framework, however, policy coordination is in danger of remaining essentially a short-term exercise in situations of near-crisis ..." 23/

43. At its meeting in April 1987, the Interim Committee of the Board of Governors of IMF "encouraged the Executive Board to examine ways in which the existing principles and procedures for Fund surveillance could be updated to incorporate the use of indicators and to submit a progress report to the Committee at its next meeting". 24/ This will provide an opportunity for building on the tentative progress to date in using economic indicators to facilitate macro-economic policy co-ordination.

IV. THE INTERNATIONAL MONETARY SYSTEM AND ADJUSTMENT WITH GROWTH IN THE DEVELOPING COUNTRIES

A. Adjustment with growth

44. In its resolution 41/202 of 8 December 1986, adopted without a vote, the General Assembly indicated that "external indebtedness ... should be tackled within the framework of a strengthened and improved strategy of co-operation of the international community for sustained world economic growth and development, particularly for developing countries" and that "a lasting solution to the debt problem also requires simultaneous and complementary actions in the areas of economic policy that are mutually supportive, and includes ... effective national adjustment processes and structural changes, pursued within national development priorities and objectives, which should be growth-oriented".

45. The structural adjustment that most developing countries need to undertake largely involves raising the capacity to produce goods that will be remunerative when sold domestically or on the world market of the late 1980s and 1990s. This will require capital investment, which is import-intensive in most developing countries. The need will be for more imports in the short to medium term, so that adequate balance-of-payments financing becomes an indispensable ingredient of a growth-oriented adjustment process.

46. This does not conform with the conventional pattern of adjustment to a current account imbalance, whereby deficit countries have been required to engineer a decrease in domestic aggregate demand and to switch resources towards the external sector. This procedure was expected to reduce imports, possibly increase exports, and thereby restore external balance. Such an approach is unlikely to be conducive to growth, particularly when adopted by many countries simultaneously. The approach is also short-term in nature, designed to have a rapid remedial effect, whereas growth requires a longer-term perspective.

47. The medium-term to long-term nature of a growth-oriented adjustment programme may be illustrated by the case of the United States. Imbalances have characterized the United States economy since the beginning of the decade. At that time, it was the avowed policy intention to remedy without delay the imbalance in the federal budget deficit. Despite continuous efforts in this direction, this objective has

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not been attained and is unlikely to be attained during the present decade. Also early in the decade, a current account deficit emerged in the United States; this was given additional momentum by the over-valuation of the domestic currency. The two imbalances increased throughout the middle years of the decade, to the extent that their rapid elimination, if feasible, would have a sizeable negative impact on the world economy.

48. The United States is a widely diversified economy and is able to produce almost any product in the world (with the exception of certain raw materials and other products requiring a particular natural endowment). By international standards, the shares of trade and of the central Government in the economy are low. Despite these advantages and its declared policy intentions, the United States has so far been unable to overcome its fundamental imbalances.

49. This situation has been sustainable because of the large inflow of foreign private capital. The capital inflow could be one of the reasons for the current account deficit; even if not a direct cause, it would have been difficult for the deficit to continue on such a scale for such an extended period without these inflows. Moreover, the unlikely event of borrowing from IMF would not have provided the United States with adequate time, nor have been able to provide it with adequate resources, to make the necessary macro-economic adjustments in its economy.

50. The adjustment process in the developing countries is no less difficult and, in many cases, is seriously compounded by their high level of external indebtedness. This exacerbates the existing difficulties that the external constraint imposes on the development process of these countries. In order to reduce this constraint, it will be necessary to increase exports at a faster rate than imports. However, in many cases, the markets for developing countries' traditional exports have deteriorated, while their capacity for import substitution is limited by their small industrial base.

51. Some improvement in the external position may be possible by adjusting relative prices through depreciation of the domestic currency, but in the longer term there is a need for major structural changes in these economies. This can be achieved only through a large programme of domestic investment in export-oriented and import-substitution activities. This need for investment contrasts with the realities of recent years, during which depressed economic conditions have caused investment as a proportion of gross national product to fall in many developing countries. The reasons for this include the poor investment outlook, the low level of domestic savings (itself related to overall economic conditions in the countries concerned) and the fact that in many developing countries, a significant proportion of domestic savings is being devoted to servicing external debt.

52. A variety of policy measures within the developing countries can improve the availability of domestic resources for investment, but it is unlikely that this will result in the mobilization of resources on the scale necessary to break the present vicious circle. In order to succeed in their adjustment efforts, the developing countries need access to adequate financing on appropriate terms. However, developments in international financial markets have not responded to this need.

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B. Developments in financial markets

53. In the 1970s, many of the energy-exporting developing countries had large surpluses in their balances of payments. Initially, these surpluses were "recycled", largely through the commercial banking system. The surplus countries deposited funds with the commercial banks, which lent them to developing countries with balance-of-payments deficits.

54. This arrangement sustained the international monetary system and world trade through a period of great international turbulence. In the absence of the recycling process, the energy-importing countries would not have been able to withstand the shocks to their external balances; their foreign exchange reserves and possible drawings from IMF would have been insufficient to meet their needs for international liquidity. The commercial banks were willing and able to provide international liquidity in the amount required and were prepared to do so without imposing the type of conditions associated with borrowing from IMF or other international institutions. A related advantage to the borrowers was that the funds were disbursed more quickly than most official lending, in part because the borrowers did not have to satisfy any pre-conditions.

55. It was in the 1970s that, for the first time in the post-war period, the private international banking community displaced official institutions (i.e., central banks and IMF) from the leading role in providing the financing necessary to overcome major balance-of-payments disequilibria. Neither the central banks of the deficit countries nor IMF was in a position to provide resources sufficient to meet the enlarged needs. The substitute arrangement was not, however, without its shortcomings. The commercial banks were selective in deciding on the countries to which they would lend. Most of the lower-income countries were regarded as high-risk borrowers and consequently did not have access to bank lending. Moreover, the lending to the higher-income developing countries ceased abruptly in the 1980s. Overall, therefore, the recycling mechanism adopted in the 1970s served only as a short-term palliative for the deficiencies in the international monetary system. It did nothing to bolster the capacity of the system to withstand further shocks.

56. International financial markets have changed considerably since the 1970s. One major development has been their increased global integration. The growth of the Euro-currency and Euro-bond markets in the 1960s was the first major move in this direction. A powerful impetus to increased integration came with flexible exchange rates, the increase in oil prices in 1973 and the subsequent rapid growth of international capital flows. The second major increase in oil prices in 1979-1980 reinforced the process. The next important event came in 1979 and the early 1980s, when British and Japanese controls on capital outflows began to be dismantled.

57. The exposure of these two major financial markets to external competition forced them to adopt an international orientation and abandon some restrictive business practices that were only possible in protected domestic markets. Competition forced other financial centres to adopt similar liberalization measures in order not to lose their business. The timing and scope of such measures differed, but they included removing interest rate ceilings, permitting the use of

new financial instruments, authorizing financial institutions to undertake previously prohibited activities, allowing foreign financial institutions to participate in selected domestic markets, and removing or relaxing restrictions on capital flows.

58. The pressure for such change would have been less sustained if national financial markets had not been linked together by instantaneous global telecommunications networks. Computer technology has facilitated not only the transactions process but also the information gathering, processing and analysis that are necessary to ascertain the viability of new and complex financial arrangements. Increased international competition has fostered the development and use of those new financial instruments.

59. One of the more recent developments in financial markets has been termed "securitization". 25/ Narrowly defined, it refers to the process by which traditional bank assets, such as loans and mortgages, are converted into negotiable securities that may be purchased and sold by other institutions and non-bank investors. More broadly, the term encompasses the development of markets for a variety of new negotiable instruments, such as note issuance facilities and floating rate notes, which can be traded in international markets. Currency and interest rate swaps have also become increasingly prominent. Forward rate agreements, which are akin to interest rate futures, are another innovation. These various instruments are replacing bank loans as a means of borrowing: lenders and borrowers are increasingly transacting business directly, using financial institutions as agents, rather than going through the conventional bank channels of deposits and loans.

60. Deregulation and technical progress have thus combined to create a larger and more efficient international financial market in which new financial instruments have risen to positions of prominence (see table 1). In the early 1980s, commercial bank lending was the dominant form of international private capital flow. Only five years later, bonds and notes had assumed this position, and floating rate notes and note issuance facilities were important alternatives to syndicated loans, offering a means of shifting interest rate risk from lender to borrower. The impact of the developments, however, has not been universal: many developing countries are integrated into the new international financial market; others, especially those lacking domestic financial markets, remain excluded.

61. The energy-exporting countries no longer have large surpluses in their balances of payments. In the 1980s, this position has been assumed by the Federal Republic of Germany and Japan, which have followed the pattern of recycling their surpluses through the commercial banking system. However, the destination of these funds tends to be the United States rather than the developing countries, and the means of transfer tends to be bonds and other negotiable instruments rather than syndicated bank loans.

62. The increased use of private capital flows as a source of liquidity means that perceived credit-worthiness has become a major determinant of a country's access to such liquidity. A lack of adequate official foreign exchange reserves or a poor balance-of-payments position is likely to cast doubt on a country's credit-

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worthiness and limit its access to international borrowing. The credit-worthiness of most of the developing countries that were able to obtain commercial credit in the 1970s has now been eroded and this source of international liquidity is no longer available to them, even though their requirements for balance-of-payments financing remain large or have even increased. From the point of view of the developing countries, therefore, the creation of new international liquidity has become highly pro-cyclical: their access to international capital markets has steadily diminished as their need for international liquidity has increased.

Table 1. International borrowing, by country group and by type of instrument, 1981-1987

(Billions of United States dollars)

Item	1981	1982	1983	1984	1985	1986	1987 (first quarter)
Country group							
Developed market economies	78.5	101.0	81.0	125.6	193.5	282.0	81.8
Developing countries	51.7	57.1	28.7	20.4	15.1	20.3	2.4
Centrally planned economies	1.1	0.8	0.8	2.7	4.2	2.7	1.1
Other a/	10.2	14.4	16.6	14.6	21.5	22.6	7.7
Type of instrument							
International bonds and notes	44.0	71.6	72.0	107.9	163.7	220.3	59.7
of which: Floating rate notes	7.8	12.6	15.3	34.0	55.9	47.8	2.7
Note issuance facilities b/	1.0	2.3	3.3	18.8	49.5	69.5	16.0
Syndicated Euro-bank loans c/	96.5	99.4	51.8	36.6	21.1	37.8	17.3
Total	141.5	173.3	127.1	163.3	234.3	327.6	93.0

Source: Bank for International Settlements, Fifty-seventh Annual Report (Basle, 1987), pp. 108 and 110.

a/ Offshore centres, international institutions and unallocated items.

b/ Including revolving underwriting facilities, multiple-component facilities (if they include a note issuance option) and other Euro-note facilities.

c/ Excluding stand-bys related to take-over activities in the United States.

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63. The higher cost of international liquidity has imposed a further limitation on its use by many developing countries. Real interest rates rose steeply in the first half of the 1980s and have since remained at an unusually high level. In many cases, the interest rate charged to developing country borrowers has been further increased because of the perceived deterioration in their credit-worthiness. This higher cost has inhibited developing countries in a position to do so from utilizing the international financial market to acquire international liquidity.

64. The situation of developing countries contrasts with that of the United States. Because its dollar is a de facto reserve currency, the United States continues to be in good standing in international credit markets and is able to draw on the resources of the global commercial banking system for additional international liquidity as required. The selective nature of international credit creation is a major shortcoming of the present international monetary system.

65. Overall, the total supply of international liquidity has grown rapidly in recent years, far outstripping the expansion of international trade. However, private sector credit has accounted for most of this growth and the developed market economies have been the primary beneficiaries. The supply of official international reserves, on the other hand, has barely kept pace with the growth of world trade: the import coverage of non-gold reserves was about the same in 1984-1985 as in 1975-1976 (see table 2). Developing countries are heavily reliant on these official reserves, rather than private sector credit, for their international liquidity. The question, therefore, is not one of the total availability of international liquidity, but rather its availability to different countries.

Table 2. Global non-gold international reserves, 1975-1986

	1975	1976	1980	1981	1984	1985	1986 a/
	(Billions of special drawing rights)						
Foreign exchange	139	162	293	292	308	348	365
Reserve position in IMF	13	18	17	21	42	39	35
Holding of special drawing rights	9	9	12	16	17	18	19
Total	160	188	321	330	407	405	420
Ratio of non-gold reserves to imports	(Weeks of imports)						
All countries	12	12	11	11	11	12	...
Non-energy importing developing countries	10	13	11	10	13	13	...

Source: International Monetary Fund, International Financial Statistics Yearbook, 1986 and International Financial Statistics, August 1987.

a/ Last quarter.

C. Official sources of liquidity

66. In the 1980s, developing countries have been required to resort largely to conventional sources - national reserves and official borrowing from international institutions - to meet their needs for international liquidity. However, the availability of internationally created reserves has not grown commensurately with the increasingly large fluctuations in the world economy to which these countries have been subject. In particular, the reserves of IMF have declined from some 16 per cent of world trade when the Fund was created to about 4 per cent at present. In terms of the ability to accommodate balance-of-payments disequilibria, the ratio of Fund quotas to the aggregate current account deficit of the developing countries in the 1980s is less than half its value in the 1970s. From a shorter-term perspective, the 1980s, with the notable exception of 1983, have seen a steady decline in the use of the Fund's resources in absolute terms (see table 3).

Table 3. Net flow of IMF lending to the capital-importing developing countries, 1981-1987

(Billions of United States dollars)

	1981	1982	1983	1984	1985	1986	Five months 1987
Regular facilities	5.7	4.2	8.8	4.3	1.1	-0.6	-1.1
Credit tranche drawings	3.3	1.9	4.0	1.2	1.1	0.3	-0.7
Extended Facility drawings	2.4	2.3	4.9	3.2	0.0	-0.9	-0.5
Special facilities	-	1.4	2.2	-0.2	-0.8	-2.1	-0.9
Buffer stock financing	-	0.1	0.3	-	-0.2	-0.2	-
Compensatory financing	0.6	1.7	2.1	-	-0.4	-1.4	-0.6
Oil Facility	-0.7	-0.4	-0.1	-	-	-	-
Trust Fund	0.1	-	-	-0.2	-0.3	-0.6	-0.3
Structural Adjustment Facility	-	-	-	-	-	0.1	0.1
Total	5.7	5.7	11.1	4.2	0.3	-2.7	-2.0

Source: International Monetary Fund, International Financial Statistics and IMF Survey, various issues.

67. The developed market economies, with access to international capital markets, no longer need IMF resources and have not needed them since a drawing by the United Kingdom of Great Britain and Northern Ireland in 1977. The relative decline in the volume of resources available from IMF has fallen exclusively on the developing countries and has served to accentuate the liquidity problems facing some of them as a result of the withdrawal of private sources of credit.

68. Total IMF lending to capital-importing developing countries has declined steadily since 1983. In the aggregate, such countries are repaying more than they are borrowing from the Fund at a time when they have also lost access to commercial liquidity. Instead of offsetting the cyclical behaviour of the commercial banking system, the flow of resources from the Fund has become pro-cyclical and has reinforced the negative consequences of the declining availability of private sector liquidity.

69. It is argued in this context that the Fund's resources are intended to be "revolving" in nature, that drawings accordingly have to be repaid on schedule, and that the Fund was not established to provide long-term, or development, finance. On the other hand, one of the purposes of the resources of the Fund is to help

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smooth out fluctuations in the external accounts of member countries. The present perverse situation arises because the time required to correct the borrowing countries' disequilibria is longer than the permitted duration of drawings from the Fund's regular tranches. This situation could be remedied, without violating the revolving character of the utilization of the Fund's resources, by increasing the duration of drawings. This would, however, require an increase in the Fund's resources or in access to them.

70. In this context, the increase in quotas by 47.5 per cent following the Eighth General Review of Quotas and the progressive reduction in access limits for 1984, 1985 and 1986 have operated at cross purposes. Access limits in effect for 1983 in the upper credit tranches were 150, 450 and 600 per cent of quotas for annual drawings, drawings over a three-year period and total cumulative drawings, respectively. After three successive reductions, these limits were reduced to 90, 270 and 400 per cent for 1986 and were left unchanged for 1987. For countries that have particularly serious balance-of-payments needs and are making strong adjustment efforts, the limits were set at 110, 330 and 440 per cent. Nevertheless, despite the increase in quotas following the Eighth General Review, the maximum access to Fund resources is now, normally, only about 8 per cent higher than it was in 1983. In practice, drawings in any one year have rarely exceeded 60 per cent of a country's quota, suggesting that policy on access has become more restrictive.

71. Allocations of special drawing rights (SDRs) are an additional form of international liquidity that can be created by IMF, and the possibility of a further allocation of SDRs has been on the international monetary agenda for several years. 26/ As argued above, the nature of the international liquidity available, especially to a large number of developing countries, remains critical. The Second Amendment to the Articles of IMF called for collaboration of members to make SDRs the principal reserve asset of the international monetary system. In reality, its role as a reserve asset has remained minuscule: a total of only SDR 21.4 billion has been allocated so far and no allocation has been made since 1981. SDRs accounted for only 4.6 per cent of world non-gold reserves in 1986, approximately the same as in the 1970s.

72. The financial resources of IMF are available to member countries through a number of separate channels, each with different terms and conditions. Some of these are more attuned to the present longer-term needs of developing countries than the conventional resources of IMF and could be used on a much larger scale to respond to those countries' present external financing requirements.

73. The recognition that supply-oriented external adjustment is a long-term process received recognition in the creation of the Extended Fund Facility. This Facility was established in 1974 to give medium-term assistance to countries with structural maladjustments in production and trade or an inherently weak balance-of-payments position. Despite the clear need of many developing countries for the longer-term financing that it provides, this Facility has fallen into disuse: as at 30 June 1987, there was only one such arrangement in operation.

74. The same is true of the Compensatory Financing Facility, which was established to provide member States with financial assistance if they encountered a temporary shortfall in export earnings for reasons beyond their control, such as a decline in the world market price for their principal export. Despite the deterioration in primary commodity markets and the wide fluctuations in developing countries' export earnings, access to the Facility has been reduced from 100 per cent of each country's quota to 83 per cent. Use of the Facility has fallen in recent years, partly because of the adoption of requirements for access - whereas the rationale behind the Facility's creation suggests that access and disbursement should have a high degree of automaticity.

75. In the 1970s, the IMF Trust Fund was created to provide official support for lower-income developing countries that were facing balance-of-payments difficulties as a result of the first oil shock but were unable to mobilize financial resources from the private sector. It came into operation in 1976 and was an *ad hoc* arrangement financed from the profits realized by selling one sixth of the Fund's gold holdings. Its resources were made available for 10 years, with a five-year grace period and interest of 1/2 per cent per annum. Although the lending operations of the Trust Fund have ceased and its loans are now maturing (which is aggravating the balance-of-payments situation of the countries concerned), it serves as an example of a longer-term adjustment facility in IMF.

76. The Trust Fund has been succeeded in many respects by the Structural Adjustment Facility. As its title indicates, this Facility, created in 1986, is designed specifically to address longer-term problems of structural adjustment. It has terms and conditions similar to the Trust Fund and is directed exclusively at low-income countries, 15 of which already have Facility loans in place. In view of the overall magnitude of the adjustment problem, however, the total volume of resources that the Facility has available - about $3.5 billion - is inadequate.

77. Moreover, this Facility does not address the needs of those developing countries at the middle and upper end of the per capita income scale that also need credit to finance their adjustment efforts. As noted above, access to the Fund's regular tranches has been progressively reduced in recent years, even though the drying up of commercial credit and other adverse developments have caused developing countries' needs for Fund resources to increase. Use of these resources has declined even more rapidly than access, to the extent that developing countries as a group became net repurchasers from the Fund in 1986, which suggests that the terms and conditions attached to the use of the main resources of the Fund are inadequately attuned to the needs of adjustment with growth in the developing countries.

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V. POLICY CONCLUSIONS

78. Some observers are encouraged by the resilience that the international monetary system has shown in weathering the economic turbulence of recent years. Nevertheless, despite the gradual adjustment to changing circumstances, some long-standing shortcomings persist and there remains considerable scope for improvement. There is still a pressing need to address some of the international monetary issues that have been examined in the reports of the Group of 24 and the Group of 10. These reports and subsequent work should continue to serve as a basis for discussions on practical measures to improve the functioning of the system.

79. Within this wider context, two issues stand out as critical in mid-1987. The first concerns the requirements for a smooth unwinding of the large imbalances among the major industrial countries. It is a major challenge to international economic management to ensure that the narrowing of these imbalances takes place in an environment of expanding output, non-accelerating inflation, rejuvenated world trade, lower real interest rates and more stable exchange rates. The second major issue involves the establishment of a framework in which developing countries with unsustainable balance-of-payments disequilibria and large debts can adjust the structure of their economies and still increase gross domestic product at a rate above the rate of growth of their population.

80. Changes in the fiscal stance of the United States (leading to a lower fiscal deficit [illegible] 1987) and the implementation of expansionary fiscal commitments by the Federal Republic of Germany and Japan should narrow the differentials between their rates of growth of domestic demand and lead to some correction of the trade imbalances. A continuation of strong and consistent actions in these directions by all three countries until at least 1990 is required to ensure that the measures are fully effective. At present, financial markets are not fully convinced of the declared commitment of the United States to reduce its budget deficit. 27/ Real interest rates therefore remain high and might increase further if the United States is unsuccessful in this area. A credible set of policies to narrow the fiscal imbalance of the United States in a consistent way remains critical.

81. It is also important that aggregate demand in countries with large trade surpluses remain strong. The unusually large trade surpluses of the Federal Republic of Germany and Japan make full implementation of the more expansionary fiscal measures announced in recent months particularly important. However, it is also a highly desirable objective to seek to redirect their surpluses towards developing countries, and Japan has already announced important initiatives to this end.

82. The impact of these proposed changes depends critically on the magnitudes involved and their timing; the co-ordination efforts of the last few years must therefore be strengthened. The present system of ad hoc meetings and agreements that are mostly a response to crisis situations needs to be replaced by a more systematic working arrangement. Through the use of objective indicators and discussions with individual countries, IMF could significantly enhance the co-ordination process, make it more systematic and take into account the interests of countries other than key currency countries.

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83. An effective surveillance process seems to have widespread support, but it has been difficult to put into practice. One major issue is that of the incentives that could be given or the sanctions that could be applied to countries that have not traditionally been subjected to external discipline and are not dependent on credit from the international financial institutions. Early exploration of and agreements on options (such as that outlined in para. 41 above) are important. Without progress in this area, it will be almost impossible to make any progress towards effective surveillance.

84. Improved domestic policies, enhanced co-ordination among large industrial countries and effective surveillance should lead to more stable and better aligned exchange rates. Nevertheless, significant instability might still persist under a system of unconstrained floating exchange rates. There is currently no agreement on how the exchange rate system could be made more stable while maintaining a necessary element of flexibility. More work is required to develop a form of target zones that could provide the technical and political answer to present global requirements for greater exchange rate stability.

85. Developments in the 1980s, particularly the fluctuations around a declining trend in primary commodity prices, high and unstable interest rates in international financial markets and the debt overhang of a large number of countries, point to the need to improve the framework for balance-of-payments adjustment in developing countries. Efforts to achieve sustainable current account balances in the medium term should be accompanied by increases in output that at least match the rate of population growth and by rates of investment that ensure an expansion of output. The process of adjustment in many developing countries in the last four years indicates that this has not been the case.

86. There are strong justifications for more emphasis on growth-oriented adjustment. At a time when many countries face balance-of-payments difficulties, restrictive adjustment policies have introduced a strong deflationary bias into the world economy. When a large number of countries try to adjust simultaneously, the result is a reduction in global demand, international trade and world output. Moreover, most of the developing countries facing balance-of-payments difficulties are predominantly primary commodity exporters. Under current conditions, efforts to increase revenues from the export of such products often have a perverse effect on total export earnings because the prices of primary commodities are likely to decline as supply is increased. The necessary structural adjustment must take the form of diversification, which requires time, investment and additional financial resources. One cause of concern is that negotiations on trade take place in a forum quite divorced from those on money and finance and that the close interrelations between these fields do not find political or institutional expression.

87. Growth-oriented adjustment has three main requirements: an international environment conducive to growth; improved domestic policies in countries with balance-of-payments difficulties; and a supportive international financial framework. As discussed in the report of the Secretary-General on the international debt situation in mid-1987 (A/42/523), the first and last of these requirements have been lacking in recent years, and their restoration remains at

the top of the international agenda. At the same time, domestic efforts by developing countries to mobilize additional private and public savings, to improve resource allocation - both among traded goods and between tradeables and non-tradeables - and to increase efficiency remain essential. Considerable efforts have been made in these directions in recent years. Their continuation is the only means of achieving self-reliance and is an important ingredient in efforts to improve the balance-of-payments position.

88. Present institutional arrangements give IMF a key role in assisting countries to formulate adjustment programmes requiring international financial support. This arrangement should be supportive of growth-oriented adjustment. First, adjustment programmes prepared in consultation with IMF should emphasize the medium-term framework for growth. Secondly, adequate levels of external finance should be provided so that balance-of-payments adjustment does not thwart growth.

89. The first requirement implies that greater emphasis should be placed on supply-side considerations. The speed of the required adjustment is a major constraint. Structural change, particularly shifting resources towards new activities, takes time. Performance criteria should be concerned with the broad lines of such agreed medium-term programmes, in particular with changes that will tend to affect trade balances permanently, rather than with short-term financial variables. There is also a case for including contingency mechanisms in the arrangements. In the recent past, many stand-by programmes have failed to achieve their objectives because of sudden, unexpected changes in exogenous variables, such as import prices and export revenues. Such events, particularly if they are short-term in nature, should not be allowed to disrupt a programme that promises to achieve the required structural adjustments in the medium term.

90. Growth-oriented adjustment programmes, by their very nature, will generally require larger amounts of external financing for more extended periods than deficit-reduction programmes financed by stand-by arrangements. This is not inconsistent with the revolving character of the resources of IMF. In the past, the Fund has been able to increase the volume of resources that it could make available through the policy of enlarged access and the supplementary financing facility. However, the adequacy of IMF resources would come into question if many countries tried to negotiate extended arrangements simultaneously. In the short run, there are several options that would allow greatly increased IMF lending. 28/ The Ninth General Review of Quotas should be used to provide the permanent increase in resources needed for an expansion of IMF activity. At the same time, the recent tendency to reduce access limits should be reversed. Above all, the Fund should not be a net recipient of financial resources when developing countries are subject to an abrupt retrenchment by private creditors.

91. The Structural Adjustment Facility was established in March 1986 in recognition of the fact that low-income countries facing protracted balance-of-payments problems needed access to financing on concessional terms to effect required structural adjustments. The enhancement of this facility, in particular an extended adjustment horizon and a level of resources sufficient to cope with the large number of countries in need, is particularly important at this

stage. An early agreement to implement the proposal of the Managing Director of the Fund to increase the resources of this Facility from SDR 3 billion to SDR 9 billion would go a long way towards meeting that objective. 29/

92. The large share of primary commodities in the exports of low-income countries and of many other developing countries and the considerable fluctuations of international primary commodity prices require enhanced channels of compensatory financing. As reflected in the Final Act of the seventh session of UNCTAD, 30/ there are several avenues for possible improvements in this area. In particular, a strengthened Compensatory Financing Facility in IMF with more automatic access in the upper tranche could ease temporary liquidity shortages affecting primary commodity exporters.

93. Fund-supported adjustment programmes have tended to come in the aftermath of a rapid depletion or virtual exhaustion of international reserves. However, such liquidity problems are not independent of other financial flows, including bilateral and multilateral official flows. A country's transitory liquidity problem will be exacerbated if it coincides with falling - or negative - net inflows of financial resources. A more assured, continuous and predictable flow of bilateral and multilateral resources is therefore another essential ingredient of growth-oriented adjustment. If the flow of development finance - concessional and on market terms - is erratic or tends to reinforce downturns in the economic cycle, the liquidity requirements of developing countries are likely to increase. In this connection, new SDR allocations could play a significant role in assisting developing countries to restore their reserves to more adequate levels. Even if closely related to quotas rather than linked to the needs of developing countries for development finance as has repeatedly been proposed, new allocations would be distributed more in line with reserve needs than funds borrowed on international capital markets for the purpose of reconstituting official reserves. The reasons for this are that credit-worthiness would not be a criterion in the allocation process and that new allocations could be timed to coincide with periods of cyclical slow-down in world economic activity.

94. It should not, however, be a function of IMF to substitute for shortfalls in development finance. The widespread support for recent measures (such as the renewal of actions by the International Development Association and the International Bank for Reconstruction and Development (IBRD) to increase net flows) should be backed by capital increases in the World Bank and other multilateral development institutions. Unless additional development finance is forthcoming, growth-oriented adjustment, even when supported by the Fund, is likely to fall short of the target, and neither growth nor balance-of-payments adjustment would be achieved.

95. This brief review of some of the salient features of the current international monetary situation would not be complete without reference to the negotiations in which the monetary situation is subject to continuing review and proposals for modification are discussed. Among the key currency countries there is intensified consultation and co-operation to enhance stability in exchange rates, although by the very nature of central bank co-operation this is not widely publicized. Some

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considerable progress has also taken place in the acceptance of common views on such issues as growth-oriented adjustment, improved macro-economic co-ordination among major developed countries and co-operative solutions to debt problems.

96. However, many major issues remain controversial. The distinction between monetary and financial issues is delicate and to some extent arbitrary, and proposals for improving the monetary situation generally involve greater financial commitments. Yet notwithstanding compelling evidence of need, the reluctance to extend more official financial resources in support of developing countries, whether through bilateral or multilateral channels, is very strong in the majority of the developed countries, most of which have suffered sharp budgetary crises in the wake of the slow-down of the 1980s.

Notes

1/ United Nations publication, Sales No. E.87.II.C.1.

2/ United Nations publication, Sales No. E.86.II.C.1.

3/ Both of these reports are contained in Supplement to World Economic Survey 1985-1986 (United Nations publication, Sales No. E.86.II.C.2).

4/ See Trade and Development Report, 1984 (United Nations publication, Sales No. E.84.II.D.23), parts II and III, and International Monetary and Financial Issues for the Developing Countries (United Nations publication, Sales No. E.87.II.D.3).

5/ International Monetary Fund, Articles of Agreement (Washington, D.C., 1985), art. I.

6/ This net transfer is receiving increasing attention in both development and banking circles. See, for example, Organisation for Economic Co-operation and Development, Financing and External Debt of Developing Countries: 1986 Survey (Paris, 1987), p. 12, and Morgan Guaranty Trust Company of New York, World Financial Markets, June/July 1987, p. 5.

7/ World Economic Survey 1987 (United Nations publication, Sales No. E.87.II.C.1) box IV.1.

8/ Ibid., table IV.3.

9/ "The functioning of the international monetary system: a report to the Ministers and Governors by the Deputies of the Group of 10" (IMF document EDB/85/154, supplement 1), para. 15.

10/ International Monetary Fund, Exchange Rate Volatility and World Trade, Occasional Paper No. 28 (Washington, D.C., July 1984).

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Notes (continued)

11/ "The functioning of the international monetary system: a report to the Ministers and Governors by the Deputies of the Group of 10" (IMF document EDB/85/154, supplement 1), para. 20.

12/ R. Dornbusch, "Flexible exchange rates and excess capital mobility", in Brookings Papers on Economic Activity, No. 1 (Washington, D.C., the Brookings Institution, 1986).

13/ J. Williamson, "Exchange rate management: the role of target zones", American Economic Review, May 1987, pp. 200-201.

14/ See R. Baldwin and P. Krugman, "Persistent trade effects of large exchange rate shocks", National Bureau of Economic Research Working Paper Series, No. 2017, September 1986.

15/ The results of a number of empirical studies on the trade effects of exchange rate variability are summarized in World Economic Survey 1986 (United Nations publication, Sales No. E.86.II.C.1), p. 99.

16/ P. De Grauwe, "Exchange rate variability and the slowdown in growth of international trade", IMF Working Paper 87/38, 22 May 1987.

17/ "The functioning of the international monetary system: a report to the Ministers and Governors by the Deputies of the Group of 10" (IMF document EDB/85/154, supplement 1), para. 28.

18/ For an overview of the arguments for and against target zones, see World Economic Survey 1986 (United Nations publication, Sales No. E.86.II.C.1), pp. 101-103.

19/ "The functioning of the international monetary system: a report to the Ministers and Governors by the Deputies of the Group of 10" (IMF document EDB/85/154, supplement 1), para. 28.

20/ See, for example, H. Ungerer et al., The European Monetary System: recent developments, IMF Occasional Paper No. 48, December 1986. Another set of data suggests that EMS has stabilized monthly rates of change more than the absolute level of exchange rates (see M. J. Artis, "The European Monetary System: an evaluation", Journal of Policy Modeling, vol. 9, No. 1 (spring 1987)).

21/ Reserve currency countries would still have an added degree of freedom since they would be able to settle their external liabilities in their own currency.

22/ "The functioning and improvement of the international monetary system: report of the Deputies of the Group of 24" (IMF document EDB/85/228), para. 78.

23/ Bank for International Settlements, Fifty-seventh Annual Report (Basle, 1987), p. 7.

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Note (continued)

24/ IMF Survey, 20 April 1987.

25/ For a more extensive description of this phenomenon, see "The changing institutional character of international financial markets in the 1980s", Supplement to World Economic Survey 1985-1986 (United Nations publication, Sales No. E.86.II.C.2).

26/ The role of SDRs and the case for further allocations are discussed at length in World Economic Survey 1986 (United Nations publication, Sales No. E.86.II.C.1), chap. V.

27/ The federal budget deficit of the United States in fiscal year 1987 should be slightly below $160 billion, compared with $220 billion in 1986. However, under current spending and tax policies, government officials project an increasing deficit in 1988 and 1989. They anticipate that the deficit will be lowered in 1988 only if some proposed deficit reduction measures are approved (Wall Street Journal, 17 August 1987).

28/ For example, the Intergovernmental Group of 24 on International Monetary Affairs has suggested that the following measures could be adopted if the level of ordinary resources in IMF became inadequate: the General Arrangement to Borrow could be activated for "bridge financing"; the Fund could supplement its resources by borrowing; SDRs could be issued, with the allocations to countries with strong reserve positions being made available to the Fund, totally or partially, to provide credit for adjustment programmes in other countries.

29/ See remarks by M. Camdessus, Managing Director of the International Monetary Fund, before the Economic and Social Council, Geneva, 26 June 1987, in IMF Survey, 29 June 1987.

30/ TD/L.3/6 and Add.1-6.

ANNEX

Proposals for convening an international conference on money issues

1. The present annex summarizes proposals that have been made in the 1980s for the convening of an international conference on monetary and financial issues. Interest in convening such a conference has surfaced periodically, but it intensified during the global recession of 1982, particularly as a result of the debt crisis that erupted in the second half of that year. The proposals are listed chronologically and their main features are briefly summarized.

2. The South-North Conference on the International Monetary System and the New International Order, held at Arusha, United Republic of Tanzania, from 30 June to 3 July 1980, adopted "The Arusha Initiative: A Call for a United Nations Conference on International Money and Finance" (A/S-11/AC.1/2, annex): Based on the premise that the post-1945 international monetary system had broken down, this initiative called for a "fundamental restructuring of the international monetary system". According to the proposal

> "A new international monetary order must serve two fundamental objectives. First, it must be capable of achieving monetary stability, restoring acceptable levels of employment and sustainable growth, and checking the present strong inflationary and stagflationary policies and tendencies in the world economy. Second, it must be supportive of a process of global development, especially for the countries of the Third World, which contain the majority of the world's poor." (A/S-11/AC.1/2, annex, para. 18)

Among measures sought in this regard were the establishment of a new currency unit as the international means of exchange and primary reserve asset, a certain degree of automaticity in the transfer of resources through the creation of reserve assets by the international community, and the establishment of a new international monetary authority.

3. In October 1981, at a meeting at Cancún, Mexico, the heads of State or Government and other officials representing 22 industrial and developing countries reached an agreement in principle to conduct "global negotiations" on world economic problems at the United Nations. While monetary and financial issues were among the topics singled out for discussion, there was no specific mention of a monetary conference. Several countries felt that the World Bank and IMF, as the sole competent bodies for these matters, should continue to fulfil their traditional roles in this area. Nevertheless, it was understood that the proposed global negotiations would include money and finance among the many economic issues to be tackled.

4. The committee constituted to prepare those global negotiations failed to agree on a suitable agenda, and the conference never materialized. Because of this failure, the issues concerning the international monetary system have continued to

be especially stressed by the majority of the developing countries. Others, including those with centrally planned and developed market economies, also have expressed an interest in negotiations about global monetary issues.

5. In a succession of statements, including his address to the General Assembly in October 1983, Sir Robert Muldoon, then Prime Minister of New Zealand, endorsed a series of actions "looking to significant changes and adjustments in the structure of trade, payments, development efforts and exchange rates". a/ Those preparations were to culminate in a conference "along the lines of the Bretton Woods Conference". b/ Such a conference, he maintained, should consider the creation of an "Economic Security Council", whose main task would be "international economic policy co-ordination". c/ He envisaged that organ as a co-ordinator of the operations of the General Agreement on Tariffs and Trade (GATT), IMF, the Organisation for Economic Co-operation and Development (OECD), the World Bank and the Bank for International Settlements. This Council might be based in IMF. He advocated that the organ should, in any case, operate under a system of weighted voting.

6. At the Seventh Conference of Heads of State or Government of Non-Aligned Countries, held at New Delhi in March 1983, the participants "stressed the need for a comprehensive reform of the existing inequitable and outdated international monetary and financial system" (see A/38/132-S/15675 and Corr.1 and 2, annex, sect. III, para. 74). To this end, they called for the convening of an international conference on money and finance for development, with universal participation, aimed at meeting effectively the development and other financing requirements of the international economy, particularly those of the developing countries, and the need for growth-oriented structural adjustments. This conference, they stated, should not be regarded as a pre-condition for the launching of the global negotiations, but would become an integral part of those negotiations when launched. The holding of such a conference was but one in a series of actions envisaged as part of a programme of immediate measures in areas of critical importance to developing countries. Measures were proposed not only in the area of monetary and financial issues, but also as regards trade, raw materials, energy, food and agriculture.

7. Subsequently, at the Fifth Ministerial Meeting of the Group of 77, held at Buenos Aires, from 28 March to 9 April 1983, the Ministers reaffirmed the decision of the Seventh Conference of Heads of State or Government of Non-Aligned Countries, urging all countries to make efforts to overcome the remaining obstacles to the launching of global negotiations and, in the meantime, to undertake efforts "to secure the Implementation of a Programme of Immediate Measures in favour of developing countries in areas of critical importance to them, including the convening of an International Conference on Money and Finance for Development, with universal participation, to become an integral part of the Global Negotiations under the aegis of the United Nations, when launched". d/

8. In April 1983, the United Nations Committee for Development Planning, at its nineteenth session, pointed out that:

> "The Bretton Woods institutions are now almost forty years old. The monetary system for which the IMF was designed no longer exists, and in many other aspects as well the Bretton Woods institutions no longer reflect contemporary realities. There are, of course, critical differences between the present situation and that which prevailed when these institutions were designed ..." e/

The Committee stressed that, in its view, there was justification for holding a conference to debate the possibilities for reform of the system for international co-operation in trade, money and finance. However, the Committee noted, it would be futile to convene such a conference "without an extensive exploratory review of the issues and of the likelihood of securing sufficient agreement on new arrangements". f/ The Committee therefore proposed that an ad hoc group should be established under the auspices of the United Nations. The group would be composed of high-level experts from diverse international agencies and bodies, particularly IMF, the World Bank, UNCTAD and GATT, and of independent personalities with extensive expertise in the pertinent issues. In the first instance, the group should examine the full range of existing proposals for reform of the monetary and trade systems. When deemed necessary, all parties concerned should be consulted. Secondly, the group should also consider possible modalities for the negotiation of change, in view of the wide diversity of interests and needs that characterized the contemporary world economy. Key items of the agenda to be tabled should cover the exchange rate system; the provision of international liquidity; the relationship between trade, investment and monetary policies; institutional needs in the field of international finance; the need for a strong development orientation of the arrangements; and a more equitable distribution of voting power in international institutions.

9. In the course of an address at the annual meeting of OECD at the ministerial level in May 1983, President François Mitterrand of France made a proposal for a new Bretton Woods. Although he was concerned almost exclusively with securing greater exchange rate stability, he went on to call for a carefully prepared international monetary conference at the highest level in the framework of the IMF.

10. Also in May 1983, at their ninth annual economic summit meeting, held at Williamsburg, Virginia, the heads of State or Government of the seven major industrial nations issued the Williamsburg Declaration on Economic Recovery. In the Declaration, they invited "Ministers of Finance, in consultation with the Managing Director of the International Monetary Fund, to define the conditions for improving the international monetary system and to consider the part which might, in due course, be played in this process by a high-level international monetary conference". g/

11. At their annual meeting in September 1982, on the eve of that year's meetings of the IMF and the World Bank, the Finance Ministers of the Commonwealth noted the vast political and economic changes that had taken place since the establishment of the Bretton Woods institutions and called for a study of the global financial and trading system as a whole and the role of the international economic institutions.

The result was a report issued in July 1983 by a group of nine experts. h/ In their report, the experts expressed the view that "the international community should now think in terms of a conference, but this should be seen as the culmination of a process rather than its initiation". To this end, they suggested that negotiations should begin on the world's financial and trading system, either informally or under the auspices of the Secretary-General and that the Preparatory Group to be created for that purpose would be required to report on the modalities and substantive issues for the conference to the Secretary-General no later than 12 months after it had been constituted.

12. The Group of 77 submitted its Buenos Aires Platform in its entirety to UNCTAD at its sixth session, held at Belgrade from 6 June to 2 July 1983. At that session, the issue of a monetary conference was embedded in considerations of the global monetary system, which should ensure "sound growth and development, and the importance in that respect of a monetary and exchange rate system which functioned and evolved in an orderly way". d/

13. At the same meeting, the German Democratic Republic submitted, on behalf of States members of Group D, a proposal i/ in which key aspects of international monetary reform were highlighted. The proposal articulated seven rules and principles to be observed in convening an international conference on money and finance. Emphasis was placed on viewing monetary affairs in a global economic and commercial context and not in isolation, on approaching all international economic issues uniformly, and on the rights of each country to maintain autonomous currency and monetary régimes as long as such régimes did not place other countries at a disadvantage. j/

14. In October 1983, the delegations of Bulgaria, the Byelorussian Soviet Socialist Republic, Czechoslovakia, the German Democratic Republic, Hungary, Mongolia, Poland, the Ukrainian Soviet Socialist Republic and the Union of Soviet Socialist Republics issued a joint statement to the General Assembly at its thirty-eighth session (see A/38/479, annex). This statement indicated that those socialist countries had noted with interest and were prepared to consider the initiative of the non-aligned countries regarding the convening of an international conference on money and finance, in which all interested States would participate, with a view to democratizing the current international monetary and financial system on a just and equal basis. They noted, however, that the final position of the socialist States regarding their participation in such a conference would depend on how the specific tasks of the conference were formulated and on the extent to which the legitimate interests of all States were taken into account during the preparatory work.

15. In June 1984, the leaders of the seven major industrial countries met in London for their tenth annual economic summmit meeting. While the communiqué issued at the end of the meeting made no explicit reference to the need for an international conference on monetary and financial issues, it did ask Ministers of Finance to consider the scope for intensified discussion of international financial issues of particular concern to developing countries in the Development Committee of IMF and IBRD. k/

16. Following the Seventh Conference of Heads of State or Government of Non-Aligned Countries (see para. 6 above), it was suggested that international dialogue would be facilitated if a high-level group of experts from non-aligned and other developing countries examined the existing monetary system in depth - how it evolved, its deficiencies and how to overcome them. Accordingly, in the autumn of 1983, the Presidents of Algeria, India, Mexico, the United Republic of Tanzania and Yugoslavia each nominated an expert to such a group. Their report, issued in September 1984, l/ stated that "the deficiencies and shortcomings in the existing monetary and financial system require urgent attention". One set of these deficiencies and shortcomings was identified as relating to issues at the level of the monetary and financial system as a whole. The report identified a second set of shortcomings as deriving from the structure of the international financial institutions. A third set of shortcomings was perceived to emanate from the policies adopted by these institutions. In the group's view, an international conference on money and finance for development would provide the most appropriate forum for all concerned nations to share their views, assess the problems and decide on solutions. The group stressed that the principal characteristics of the proposed conference should be: (a) coverage of monetary and financial issues with a development orientation; (b) voluntary universal participation; and (c) a decision-making process based on consensus. The group also stressed the need for intensive preparation for the conference and appended an illustrative agenda that envisaged four main topics, namely: (a) monetary issues; (b) financial issues as they pertain to official and private flows and external debt; (c) the decision-making process; and (d) related trade issues. Among the array of monetary issues, five areas were to be highlighted: the adjustment process; the exchange rate régime; surveillance and policy co-ordination; international liquidity and related issues; and IMF lending and conditionality.

17. Also in September 1984, the Intergovernmental Group of 24 on International Monetary Affairs (Group of 24) presented its "Revised programme of action towards reform of the international monetary and financial system". m/ This was an update of the Group's 1979 report entitled "Outline for a programme of action on international monetary reform", n/ which had been endorsed by the Group of 77 and presented to the international community at the annual meetings of the World Bank and IMF for that year. In the revised programme, it was noted that major changes had taken place in the world economy since the first statement of 1979. However, in the view of the Group, these experiences only seemed to re-emphasize that existing international monetary and financial arrangements were grossly inadequate to achieve the basic objectives of international monetary stability and sustained growth. Accordingly, they stated that "there should be no further delay in moving toward a thorough-going reform of the international monetary system". Moreover, it was argued, that that "requires a convening of an international conference as an important and essential step" and that "the necessary preparations for such a conference should be initiated as early as possible". o/

18. In response to General Assembly resolution 39/218 of 18 December 1984, entitled "Development and international economic co-operation", a note verbale was sent out by the Secretary-General soliciting the views of Governments and United Nations bodies on expanding international co-operation in the fields of money,

finance, debt and resource flows. In their responses, a number of countries (including China, the German Democratic Republic, India, Indonesia and Poland) called for the convening of an international monetary and financial conference. Others (including the Byelorussian Soviet Socialist Republic and the Union of Soviet Socialist Republics) indicated their readiness to examine constructively the initiative of the developing countries to hold such an international conference.

19. At a meeting in August 1985, the Deputies of the Group of 24 approved a report in which many of the points in the Group's revised programme of 1984 were reiterated and it was again stated that "an effective reform of the international monetary and financial system requires a convening of an international conference". p/

20. At the 33rd and 34th meetings of Ministers of this Group, held on 5 March 1986 and 8 April 1986 respectively, the Ministers "reaffirmed that an effective reform of the international monetary and financial system requires the convening of an international conference". q/ They further expressed the view that a representative committee of Ministers from developing and industrial countries should be created to examine proposals of the Group of 10 and the Group of 24 for the reform and improvement of the international monetary system and to take the necessary steps in preparing for such a conference.

21. In September 1986, at the Eighth Conference of Heads of State or Government of Non-Aligned Countries, held at Harare, Zimbabwe, the participants indicated deep concern at the lack of progress in ongoing efforts to effect meaningful reform and to restructure the international monetary and financial system (A/41/697-S/10392, annex, sect. II, para. 39). In this regard, they reiterated the need for the early convening of the international conference on money and finance for development proposed at their Seventh Conference.

22. Also in September 1986, at the 35th meeting of Ministers of the Group of 24, it was reiterated "that an effective reform of the international monetary and financial systems requires the convening of an international conference", r/ and the Ministers expressed the view that the proposed representative committee of Ministers would be an effective step in preparing for such a conference. This point was made again at the 36th meeting of Ministers on 8 April 1987. s/

23. Most recently, it was noted in the Final Act of the seventh session of UNCTAD, held at Geneva from 12 to 31 July 1987, that:

> "Many UNCTAD members proposed an international conference on money and finance for development with universal participation, with the aim of evolving a stable, effective and equitable monetary system. Other members did not agree to the need for such a conference and indicated that the issues were being, and should continue to be, dealt with satisfactorily in the Interim Committee of the IMF and the Development Committee of the World Bank and the IMF." t/

24. Despite the variety of proposals for a conference that have emerged since 1980, there appears to be a common thread motivating them, namely agreement that

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the existing monetary, financial and trade institutions were set up at a time when the economic and political situation and the philosophy underlying international economic co-operation were quite different from the environment that has prevailed in recent years. Alhough some modifications have been introduced since the inception of these institutions, basically to come to grips with developments that were very different from the consensus of the 1940s, serious questions have arisen in the last two decades regarding the ability of the system to cope with current and emerging problems, including the slow-down of economic growth in the North in conjunction with persistently high rates of unemployment, and poor prospects for dynamic economic development in the South. The result has been various attempts at more comprehensive reform of the Bretton Woods system and repeated calls for the convening of a new global monetary conference.

Notes

a/ Robert D. Muldoon, "Rethinking the ground rules for an open world economy", Foreign Affairs, Summer 1983, p. 1080.

b/ Ibid., p. 1094.

c/ Ibid., p. 1095.

d/ See Proceedings of the United Nations Conference on Trade and Development, Sixth Session, vol. I, Report and Annexes (United Nations publication, Sales No. E.83.II.D.6), annex VI.

e/ Overcoming Economic Disorder. International Action for Recovery and Development (United Nations publication, Sales No. E.83.II.C.2), para. 91.

f/ Ibid., para. 93.

g/ IMF Survey, 13 June 1983, p. 172.

h/ Towards a New Bretton Woods: Challenges for the World Financial and Trading System: Report by a Commonwealth Study Group (London, Commonwealth Secretariat, 1983).

i/ "The world economic situation with special emphasis on development" (TD/L.230).

j/ The place of this statement in the attitudes of the socialist countries towards the international monetary system is examined in "International monetary reform and the socialist countries", Supplement to World Economic Survey 1985-1986 (United Nations publication, Sales No. E.86.II.C.2), pp. 1-27.

k/ IMF Survey, 18 June 1984, p. 189.

l/ Directions for Reform: The Future of the International Monetary and Financial System (Sahibadad, India, 1984, Vikas Publishing House Pvt. Ltd).

Notes (continued)

m/ Intergovernmental Group of 24 on International Monetary Affairs, *Documents of the G-24, 1972-1986* (Washington, D.C., March 1986), pp. 229-243.

n/ *Ibid.*, pp. 217-228.

o/ *Ibid.*, p. 243.

p/ *Ibid.*, p. 260.

q/ *Ibid.*, p. 160, and Intergovernmental Group of 24 on International Monetary Affairs, "Communiqué on the thirty-fourth meeting of Ministers", mimeo (Washington, D.C., April 1986), p. 9.

r/ Intergovernmental Group of 24 on International Monetary Affairs, "Communiqué on the thirty-fifth meeting of Ministers", mimeo (Washington, D.C., September 1986), p. 12.

s/ Intergovernmental Group of 24 on International Monetary Affairs, "Communiqué on the thirty-sixth meeting of Ministers", mimeo (Washington, D.C., April 1987), p. 13.

t/ TD/L.316/Add.1, para. 32.
