THE POLITICS OF MONEY

by John G. Ruggie

A decade has passed since the collapse of two central features of the Bretton Woods monetary system: the gold-convertible dollar and fixed rates of exchange for currencies. Today, the international community is still without a workable replacement.

U.S. policy makers direct their attention to this area of economic policy only episodically. They say that the key to a sound international monetary system is the proper management of domestic economies and that keeping the international monetary system on a dollar standard is in the American national interest. The first claim is an unhelpful truism; the second is accurate in only the most narrow and shortsighted sense.

The developing countries and America's European allies have clamored for fundamental reform of the international monetary regime for the past decade, and they have expressed particular concern about the central role of the dollar in the current system. They argue that world inflation and international financial instability had their roots in the permanent and growing U.S. balance of payments deficit even before the dislocations produced by the oil price hikes of the 1970s. Because the dollar serves as the world's major reserve currency, this deficit contributed to an expansion of national money supplies everywhere.

Observers abroad also contend that feeble U.S. attempts to reduce that deficit at the end of the 1960s helped trigger a major expansion of the Eurocurrency markets. These actions, in turn, facilitated the enormously destabilizing currency flows, which eventually put an end to the system of fixed exchange rates. Further, most economists regard the depreciating value of the dollar as a major ingredient, with inflation, in triggering oil price increases that have

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further destabilized the international monetary system.

International monetary reform alone will not solve the fundamental problems of the world economy. It can contribute, however, to the accomplishment of at least four objectives that ought to rank high on the Reagan administration's agenda. First, it would provide greater stability in currency exchange rates and in both international and domestic capital markets, thereby increasing confidence in the climate for international trade and domestic investment. Second, international monetary reform could assist in the development of a more comprehensive approach to the problem of global inflation. Third, reform could relieve domestic policy instruments of the need to respond to successive crises in the international monetary system, making them available for the pursuit of national economic objectives. Fourth, a genuine attempt at reform would improve Washington's relations with its allies, with the Organization of Petroleum Exporting Countries (OPEC), and with the developing countries.

Presidential candidate Reagan followed precedent and took no explicit position on international monetary reform. Thus far, his administration has declared no policy on the issue, except for allowing greater fluctuation in the exchange rate of the dollar. Two groups, however, are vying to shape the international monetary policy of the administration: the minimalists and the monetarists. Both are inspired by the image of the self-regulating market. They reject the normative framework of international monetary collaboration, which has guided policy in this domain throughout the postwar period, arguing that it permits too great an intrusion of the state into the market.

In attempting to implement its own vision, the administration is very likely to encounter several sets of problems. Even though both the minimalists and the monetarists are inspired by the same underlying image, their specific policy prescriptions are inconsistent, so that some compromise will have to be struck between them. In addition, the normative framework of collaboration that both groups reject still embodies the broad obligations to which governments are committed in the interna-

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tional monetary sphere. Moreover, it is the only such framework imaginable within which the contradictory postures of the minimalists and the monetarists can be at all reconciled. And bureaucratic politics as well as domestic and international power asymmetries will have at least as much of a role in determining policy outcomes as concern with economic efficiency. Thus, simple market rationality provides no cure for what ails the international monetary system. In addition to rationality, reform must be predicated upon an appreciation of the political economy of international monetary affairs.

Minimalists and Monetarists

One of the major intellectual forces behind the minimalist group is Lewis Lehrman, chairman of the Lehrman Institute. Lehrman rejects Keynesianism and monetarism alike, accusing both of elevating the state over the market, one by fiscal policy and the other by monetary policy designed to influence the level of domestic production, employment, and prices. Neither restrains state spending, which is largely to blame for endemic inflation.

Lehrman prescribes a return to the classical gold standard of the late nineteenth century. He argues that this regime would impose not only strict discipline on domestic economies; it would also impose the kind of discipline least susceptible to narrow sectarian pressures because universal monetary convertibility into gold at fixed prices systematically limits the quantity of external financial claims that central banks can create. Furthermore, because the gold standard requires no official reserve currency, it would insulate the international monetary system from the vicissitudes of the monetary policy of a dominant country, whose good behavior for the sake of international financial stability cannot be taken for granted.

But given the great quantity of dollars now held abroad by foreigners who would prefer a more secure asset, rapid adoption of the gold-convertible dollar would be like applying strangulation as a cure for obesity—sure to work, but at some cost to the patient. And in view of the degree of integration of international money markets, incremental implementation might be undermined by speculative

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capital flows so that, ironically, the minimalist solution could require increased governmental control over capital movements.

Professor Milton Friedman speaks for the monetarists. Also inspired by the market metaphor, the monetarists differ from the minimalists in favoring a system of freely floating exchange rates. They believe that the laws of supply and demand in the international market would determine the price of currencies in a more efficient and fair manner than a system relying on governmental actions. Moreover, by serving as a buffering mechanism, freely floating exchange rates are thought to be more effective in insulating domestic economies from external disturbances. The policy instruments ordinarily needed to correct disequilibriums in balance of payments can then be used to pursue domestic objectives.

In addition, like the gold standard, such a system avoids the instabilities associated with the use of a particular national currency as the world reserve currency. Inasmuch as market-induced exchange rate changes would serve as the automatic adjustment mechanism, ultimately no official reserve currency would be required. Presumably, in the short run, a transitional multiple-reserve currency system is preferable to a single reserve currency because it reduces monopoly power in the international monetary system.

The transition to such a regime, however, could take place only at high financial and social cost. Totally freeing the dollar on the foreign exchange markets would damage relations with both America's West European allies and oil exporting countries, as did the deliberate, benign neglect of the dollar early in the Carter administration. Moreover, the monetarist solution assumes that decisions of domestic authorities will have little effect on the strength of currencies internationally. But the international strength of the dollar in 1980 resulted largely from the draconian interest rates set by the Federal Reserve Board to control excessive growth in the domestic U.S. money supply.

As long as national monetary authorities remain the most potent market forces, exercising their market power in pursuit of domestic ob-

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jectives, the image of a self-regulating market determining exchange rates will remain pure illusion. As the difficulties inherent in implementing either the minimalist or the monetarist approaches become apparent, the Reagan administration is very likely to gravitate toward the existing international monetary framework because its logic is politically compelling.

The working assumption of the Bretton Woods regime was that governments had a commitment to seek stability in the levels of domestic economic activity and prices and to adhere to an international framework of multilateralism, without sacrificing one objective to the other. Under a pure gold standard, the overriding monetary objective is the maintenance of the gold parity of a country's currency. Balance of payments considerations therefore govern domestic economic policy. Under a system of freely floating exchange rates, the external value of a national currency ceases to be of official concern. Instead, the primacy of domestic objectives is asserted, and the burden of adjustment is shifted onto the international economy. Impressed by the history of monetary relations in the interwar period—by the deflationary consequences of attempting to maintain gold parities before 1931 and the mutually destructive consequences of flexible exchange rates thereafter—those who designed the regime sought a formula that avoided the disadvantages of both.

The basic design of the Bretton Woods system reflected this desire. Under collective surveillance, non-discriminatory payments facilities and stable exchange rates, on the one hand, were balanced by provision of credit to finance temporary payments deficits and by sanctioned use of certain external adjustment mechanisms, on the other. The arrangement failed because of the inadequacy of some of its policy instruments, especially those for the creation of international liquidity and balance of payments adjustments. The monetary reforms of the last 20 years have attempted to address these shortcomings.

Insofar as the basic premise of Bretton Woods represented a reconciliation of domestic flexibility with external constraint, both the monetarists and the minimalists may find that

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they have a stake in this normative framework, if not in the techniques the regime has employed in the past. The dialectic between the two groups may produce policy instruments that adapt this framework more effectively to the very different international economic environment that has emerged recently.

Ill-Equipped Monetary Technicians

Just as that adaptation cannot ignore the basic premise of the existing monetary system, so it cannot neglect the history of international monetary reforms. That history bears close scrutiny because it depicts an utter rut, seemingly incapable of yielding adequate solutions.

The monetary regime has been in trouble since it first began to function as intended by its designers. In 1958 U.S. gold reserves fell permanently below U.S. overseas liabilities, just as the Europeans returned to full convertibility of their currencies, permitting implementation of the postwar arrangement. Before the next year was out, Professor Robert Triffin had articulated his famous dilemma: If the United States corrected its balance of payments deficit, the result would be world deflation because gold production at $35 an ounce could not adequately supply world monetary reserves. But if the United States continued running a deficit, the result would be the collapse of the gold-exchange standard because U.S. foreign liabilities would exceed by far its ability to convert dollars into gold on demand.

Throughout the 1960s, a seemingly endless series of stopgap measures was effected in an effort to devise what Robert Roosa, former under secretary of the treasury, called "outer perimeter defenses" for the dollar. Multilateral agreements kept the price of monetary gold at $35 an ounce, and persuasion prevented other countries—Canada, West Germany, and Japan—from converting dollars into gold.

The United States undertook various measures itself to encourage other countries to hold dollars without converting them into gold; so-called Roosa bonds, for example, were denominated in the currencies of the holding countries. The United States supported sterling, which served as a lightning rod for speculative attacks, thereby shielding the dollar. The re-

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sources available to the International Monetary Fund (IMF) were expanded through quota increases, the General Agreements to Borrow, and Special Drawing Rights (SDRs). Central banks made currency swap arrangements in order to neutralize the flow of speculative capital. Pressure was applied on surplus countries to force them to appreciate the value of their currencies. The United States imposed voluntary and later mandatory guidelines on some capital exports and began more active forward intervention in foreign exchange markets.

By 1968, however, the dollar in effect had become inconvertible into gold; it was declared formally so in 1971. Another major pillar of the Bretton Woods arrangement—fixed parities for exchange rates—was subsequently abandoned after an early attempt to find new supportable par values.

Economist Fred Hirsch adduced a pattern in these efforts at monetary reform. He argued that only the threat of imminent breakdown would energize the deliberative process sufficiently to permit real consideration of fundamental reform. However, if the threat waned or was momentarily obscured, the move toward fundamental reform would falter. Instead of comparing the proposed alternative with the status quo as a comprehensive package, policy makers would proceed in piecemeal fashion, item by item. In such a comparison, Hirsch argued, the objections expressed by existing agencies or private interests would receive more attention than the impact of the new arrangements on the national and international economies as a whole. As a result, the comparison would prove inherently unfavorable to any new scheme: The benefits of the proposal would appear to offer only diffuse promise to the collectivity while the costs of change would both appear concrete and strike the very agencies and interests negotiating the change.

Certain consequences follow from this pattern of decision making. Change is incremental even when its avowed objective is fundamental reform. Furthermore, the reform measures that are adopted are so truncated that they can only supplement existing arrangements, never substitute for them. In addition, although steps toward fundamental reform end up as mere

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supplements to the status quo, the introduction of new elements into the system reinforces future inconsistencies, triggering the cycle all over again.

This pattern is apparent today in the inconsistent progress toward the so-called dollar substitution account. The precipitous decline of the dollar throughout 1977 and 1978 ravaged the value of the approximately 80 per cent of world foreign exchange reserves that are held in dollars and forced the idea of a substitution account onto the negotiating agenda. This IMF facility, initially involving $20 billion, would allow foreign central banks to exchange unwanted dollars for an asset denominated in SDRs, rather than dumping the dollars onto the market or being forced to hold onto them. IMF gold sales and a contribution by the United States, whose liabilities these foreign-held dollars represent, would finance the interest payments and provide a guarantee against possible foreign exchange losses from the account.

The United States has refused to make the interest payments sufficiently attractive, however, so that if the account does come into existence, it will be assured of a minor supplementary role. In part as a compensatory response to these developments, and in part because of recent increases in oil prices, West Germany, Japan, and to a lesser extent Switzerland have permitted their currencies to play a larger reserve role than in the past. This situation has obscured just who has what interests at stake in which aspect of a new substitution account and so has befuddled the negotiations.

The scramble for liquidity following the most recent wave of OPEC price hikes further defused the momentum toward agreement, there being no short-term problem of excess dollars while these increases were recycled through the system. Negotiations on the substitution account broke down in spring 1980, but they will undoubtedly recommence at some time in the near future. Next time around, if the past is any guide, they will produce a substitution account as circumscribed in its use and as unattractive to hold as was the SDR when it was first created.

The only real exception to this pattern of circumscribed reform occurred in 1971, when

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the Nixon administration put an end to dollar convertibility into gold. Whatever one may think of the action on substantive grounds, that administration momentarily rescued international monetary policy from the domain of the monetary technocrats. And therein lies a lesson. Lehrman is correct when he argues that policy in this domain is not simply a question of technique, but is essentially political and even normative in nature. Monetary technicians are ill equipped to formulate political and normative objectives. In the absence of such guiding objectives, they produce the kinds of technical compromises that result in the pattern of reforms depicted above.

A New Way of Thinking

But if neither the market nor the technocrats offer acceptable solutions, what then is to be done? Successful reform will depend on making a set of political decisions about the just distribution of costs and benefits produced by the international monetary regime. These, in turn, must take into account three recent structural changes in the world economy.

First, the distribution of economic power among the major industrialized states and the developing countries, especially the members of OPEC, has shifted. When the United States put an end to the gold-convertible dollar, it demanded the right to manage its own currency in the pursuit of national economic objectives, just like any other country. This right, although entirely legitimate, is fundamentally incompatible with the U.S. practice of deciding for the world economy as a whole the most central of issues in any economy: How much money will be created, and who will be entitled to create it. If the United States insists on having it both ways, it will be at the short-term cost of increasing resentment abroad and encouraging instability in the international monetary system. The potential long-term cost will be to undermine multilateralism, which has been the very cornerstone of U.S. foreign economic policy for nearly half a century.

Second, the international economic power of private financial actors and markets has increased tremendously. The Eurocurrency market has grown at 20 per cent a year, a rate

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at which it doubles every three to four years. Its gross size, a figure that is of greater symbolic than practical consequence, exceeds $1 trillion. Together with the 24-hour foreign exchange markets and the increasingly sophisticated and aggressive currency portfolio management of multinational corporations, the Eurocurrency market comprises a feature of the international economy that can impair the effectiveness of both domestic and international policies of governments. Banking sources and even monetary authorities have been too content to believe that the Eurocurrency market is a neutral transmission belt, merely conveying stabilizing or destablizing forces, but not contributing to them. On the contrary, the effects of a market that has achieved such scope and momentum cannot possibly be neutral and must be kept in mind at all times as an important and possibly determining factor in domestic and international monetary affairs.

Third, the era has ended in which international economic policy simply facilitated domestic fine-tuning of the process of expansion in production and trade through macroeconomic measures. More contextually specific policy instruments are required—at the international level, instruments that recognize, for example, the difference between inflation produced by excessive pressure of domestic demand and that stemming from rising costs resulting from new structural features in the international economy. This new way of thinking is particularly critical in the realm of balance of payments stabilization policies for the developing countries.

Unless either the minimalists or the monetarists gain the upper hand, any likely compromise between the two will mean that the Reagan administration will end up pursuing a tempered market-oriented strategy in international monetary relations that will not differ appreciably from the last two years of the Carter administration. In the short run, this approach will suffice in many areas of policy—for example, in the realm of exchange rates. But because of the structural changes depicted above, it will not suffice in others. The changes suggest the need for government intervention to regulate the effects of power shifts and ex-

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tant asymmetries in several key sectors of the international monetary system. The Reagan administration will find the demand for intervention particularly pressing in three areas: in the case of the reserve asset problem, on the Eurocurrency issue, and in distributing the burden of international adjustment.

> *The Reserve Asset Problem.* The United States continues to supply about 80 per cent of foreign exchange reserves. Many countries, especially some of the oil exporting countries, have managed to diversify somewhat out of the dollar. But the dollar holdings of France, West Germany, Japan, Switzerland, and the United Kingdom have actually increased since 1970, to more than 93 per cent of these nations' total foreign exchange reserves. This increase is not the result of a desire for additional dollars, but of active intervention in foreign exchange markets in order to protect their own exchange rates. Nor can they diversify easily without adversely affecting the values of their portfolios. To expect the West Europeans to put up with this state of affairs indefinitely is a delusion not widely held outside of official circles in the United States.

The free market solution to this problem is to encourage the further emergence of a multiple-currency reserve system. Deutsche marks now constitute 10 per cent of foreign exchange reserves (although a significant portion of these are held as Eurodeutsche marks); Swiss francs and yen, 5 per cent each. An international reserve role is also foreseen for the European Monetary System's partially gold-backed European Currency Unit.

The difficulty with this solution, which of course will not prevent the monetarist contingent from fervently advocating its adoption, is that it will not work. The West Germans, Swiss, and Japanese are unlikely to produce sufficient quantities of their currencies to make a multiple-currency reserve system viable. Even if they did, the instability that now attends the desire to shift out of dollars would be magnified several times over so that active exchange rate management by governments would become nearly impossible. Although this outcome may be precisely that intended by the advocates of freely floating exchange rates,

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from a political vantage point the breakup of the international monetary system into exclusive currency blocs seems equally likely.

In the final analysis, then, there is no alternative but to deal directly with the fundamental political asymmetry embodied in the current international monetary regime. In this regime, the United States insists on the right to produce the bulk of international reserves, but has rejected any obligation to convert these external claims into a non-currency reserve asset such as gold or SDRs, or even to manage the process of reserve creation in keeping with any interest but its own.

A settlement of the reserve asset problem during the next four years is not likely; indeed, the problem may not even be seriously negotiated. But the issue of the substitution account will certainly reappear on any negotiating agenda. When it does, it should be adopted in a form that is sufficiently substantial and attractive for it to make a difference—not only in terms of attenuating the short-term destabilizing effects of portfolio diversification, but also as a contribution to a long-term transformation toward an international monetary regime in which rights and obligations are more closely matched than they are at present.

International monetary reform could assist in the development of a more comprehensive approach to the problem of global inflation.

> *The Eurocurrency Problem.* The spectacular growth of the Eurocurrency markets and its coincidence with the collapse of fixed exchange rates, the overexposure of commercial banks (chiefly in the Eurobanking sector) in certain parts of the world, and the sharp increase in global rates of inflation have prompted some observers to propose more vigilant scrutiny and control of these markets. The crucial difference between the Eurocurrency market, say, for dollars and the domestic capital market in the United States is of course their respective regulatory environments. There are no minimum reserve requirements on Eurodeposits, so that Eurodollar and other Eurocurrency banking

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can both pay and charge more competitive rates than is possible domestically. For the same reason, Eurobanking tends to be more aggressive than banking in the United States.

On the question of exchange rate stability, there is little doubt that Eurocurrency markets amplified destabilizing financial flows during the late 1960s and early 1970s and that these disturbances contributed to the demise of the system of fixed exchange rates. Indeed, it seems to be widely accepted that under current conditions unregulated international capital markets in any form are fundamentally incompatible with greater exchange rate stability. The Eurocurrency markets are not the cause of this development, simply its most efficient manifestation. With respect to the financial safety of Eurobanking, monetary authorities are at this time discussing a number of so-called prudential controls, and the banks themselves are leading the parade to the IMF for regulatory help in connection with past and present lending activities.

The impact of Euromarket expansion on world inflation is a more complex issue. The existence of Eurocurrency markets makes it difficult for governments to estimate monetary aggregates and select appropriate targets for monetary restraint. Since the denomination of these currencies does not indicate their ultimate destination—Eurodollars do not necessarily end up in the United States—authorities can err in either direction. The total amount of all currencies now considered stateless and therefore problematical from this point of view is between $150 billion and $170 billion.

Eurocurrency activities have also led to some increase in both domestic monetary assets and international reserves in excess of what would exist in their absence. Although most estimates indicate that the impact of the Eurocurrency markets on the expansion of the world money supply is less than 10 per cent, that impact is growing at an increasing rate.

Moreover, the existence of the Euromarket for dollars—72 per cent of all Eurocurrency banking is denominated in dollars—may force monetary authorities in the United States to intervene more massively than the domestic situation alone would warrant in order to

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achieve significant credit restraint in the consolidated domestic and Eurodollar markets. Higher domestic interest rates have to be employed to compensate for the higher rate of expansion of the Eurodollar component of the combined markets. As governments attempt to reduce inflation, this disproportionate burden of restraint on the domestic economy is very likely to grow, not only because the Eurodollar component of the combined markets is growing more rapidly than the domestic component, but also because this administration, at least in the short run, is quite likely to rely even more heavily than past administrations on money stock control as its chief anti-inflationary weapon. In this sense, the Eurodollar market is an obstacle to inflation control and domestic economic recovery.

The administration may find it hard to withstand political pressure to offset the imbalance of the freedom of private international transactions and the cost of domestic public welfare. The most obvious response would be to try to equalize the regulatory environments of the domestic and international markets.

The Carter administration initiated two steps in this direction: greater deregulation of domestic banking and the creation of free banking zones, encouraging the overseas money markets to come physically, if not jurisdictionally, onshore where their transactions will become more transparent. Although banks in these zones would lend in dollars as well as in other currencies, these dollar transactions would not be subject to the restraints normally imposed on them in the United States. They would have the same status as standard Eurobanking activity.

However, as long as differences remain between regulatory environments, the existence of an offshore money market in New York or elsewhere in the United States may trigger a shift from domestic to free-zone banking by large corporations for which the $500,000 minimum transaction is a minimal hurdle. This shift would then exacerbate rather than alleviate the disproportionate burden of restraint imposed on the domestic economy. Nevertheless, with the United States itself a host country to these money markets, the administration

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would be in a better position to negotiate with the host countries of other Eurocurrency centers, with more leverage in regulatory discussions aimed at bringing the expansionary potential of the markets under control.

> *The IMF and the Burden of International Adjustment.* The developing countries have increasingly shouldered a burden of adjustment arising from international balance of payments disparities that is out of proportion to their responsibility for the problem. The industrialized countries can offset to some extent the effects of the new energy terms of trade and other structural changes in the international economy, but most developing countries find it extremely difficult to do so. As a result, real wages and income distribution are suffering in many developing countries, straining the social fabric of even the relatively prosperous Third World nations.

Although the developing countries have to accommodate themselves to external change, they are usually offered insufficient amounts of the wrong sort of aid from the IMF. During the period 1974-1977, the IMF provided less than 5 per cent of the external financing needs of the developing countries. In the extremely difficult year 1974-1975, the developing countries left the higher credit tranches of the fund virtually untouched: They needed the assistance, but the domestic social costs of accepting the stabilization packages that came along with aid were simply too high. The IMF packages are designed primarily to curb excessive domestic demand, but the developing countries are plagued by inflation resulting from staggering import prices, especially for energy and for the entire range of goods whose prices have risen to reflect new energy costs.

The IMF has recently agreed to offer a greater variety of assistance on more liberal terms than in the past. Two additional developments are imperative, however, before the IMF can assume a more effective role in international adjustment and stabilization. The first is the formulation of conditionality provisions that distinguish between imbalances resulting from external as opposed to internal factors. As the European Economic Community has shown with its Stabex fund, such distinctions are tech-

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nically possible. Second, the IMF must borrow additional resources in the private capital markets. This step would relieve some of the pressure on the commercial banks, which are now less anxious to become involved in lending to the less developed countries than they were in the 1970s. It would also bring recycling under greater multilateral surveillance. Presumably, this step would also give the IMF greater flexibility in its own lending program than it is currently able to achieve when borrowing from governments.

For 20 years, the basic pattern of international monetary reform has consisted of stopgap measures to shore up the dollar. The dollar will continue to play a leading role in public and private international transactions for the foreseeable future, but the recent structural changes in the world political economy make it clear that past patterns of reform are now insufficient and even counterproductive. At the same time, proposals for reform inspired by pure market rationality are unlikely to help.

Adoption of the gold-convertible dollar would be like applying strangulation as a cure for obesity—sure to work, but at some cost to the patient.

The proposals offered here—establishment of an effective substitution account, improved regulation of the Eurocurrency markets, and increased availability of IMF resources on more flexible terms to the developing countries—are useful first steps. They should provide an opportunity to control the growth and movement of the currency flows that are doing so much to fuel instability. At the same time, they should help those countries that cannot cope with the effects of the international monetary imbalances and that bear the least responsibility for these to play a greater role in global economic recovery. Taken together, these recommendations could form the beginning of an approach that would avoid the rut of past reforms while acknowledging the fundamental economic, political, and social objectives upon which international monetary cooperation is based.

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