I Introduction

With the celebration of the fiftieth anniversary of the Bretton Woods Conference in July 1994, attention has naturally focused on the performance of, and suggestions for improvements in, the international monetary system. The Articles of Agreement of the IMF, which spell out the rules that govern the international monetary system, make clear that it is a means of promoting international trade in goods and services, as well as capital flows, with the objective of achieving high levels of sustainable economic growth and stability across the international economy. Hence, the functioning of the international monetary system cannot be assessed as an end in itself. Rather, it needs to be assessed in terms of how well it promotes the ultimate objectives of economic growth and stability. Consequently, proposals for reform of the system should be evaluated in terms of the extent to which they will contribute to achieving these underlying objectives. As the central international monetary institution, the IMF has the key role of overseeing the system and ensuring that members fulfill their obligations toward the IMF and each other so as to facilitate the achievement of these objectives.

Two key interrelated parts of the international monetary system are exchange rates and capital flows. The Bretton Woods system, which was in place from 1946 to 1973, put much more emphasis on the former part; the system was primarily concerned with promoting stability in exchange rates and in economic conditions more broadly, so that the chaotic situation of the 1930s regarding trade and international payments would not be repeated in the postwar world. What was not then foreseen was the extraordinary expansion in international capital markets over time. As private capital flows have come to play a key role in determining exchange rates and financing external imbalances in many countries, a discussion of possible improvements in the international monetary system must consider both exchange rate arrangements and the role of capital flows for the functioning of the system.

In contrast to the Bretton Woods fixed exchange rate system, an important feature of the current international monetary system is the diversity of exchange rate arrangements. In particular, bilateral exchange rates between the three largest industrial nations—the United States, Japan, and Germany—have operated under a regime of managed floating since the early 1970s. Under this regime, the authorities are not indifferent to the behavior of their currencies. Official intervention, both unilateral and coordinated, is used by all three countries at times to influence their exchange rates. On occasion, macroeconomic policies, including monetary policy, are adjusted in light of exchange rate developments, and these three countries, in concert with the other major industrial countries, have at times coordinated these actions. However, no consistent, determined effort is made to adjust their economic policies with the intent of keeping their exchange rates within announced and relatively narrow limits or ranges. These three large countries have generally accepted fluctuations in their bilateral exchange rates across quite wide ranges and have oriented their basic economic policies primarily toward other objectives.

Other countries are able to choose the exchange rate arrangements that are deemed most appropriate for their particular circumstances. Participants in the exchange rate mechanism (ERM) of the European Monetary System (EMS), for example, have agreed to limit the variation in their bilateral exchange rates within set bands, while many other countries, particularly in the developing world, choose to peg their rates against specific currencies or baskets of currencies.

This decentralized and flexible system has proved quite resilient in the face of economic disturbances and trends. It was able to cope with the oil crises in 1973 and 1979 without experiencing significant strains in exchange markets, despite the relatively divergent macroeconomic responses across countries to these events. The system has likewise accommodated the different cyclical conditions experienced by many countries in the 1980s and early 1990s. More generally, it has adapted relatively smoothly to secular trends in the world economy, including the expansion in the breadth and depth of private capital markets.
over time and the growing importance of Japan and Europe in world capital markets.

That being said, some observers have regarded the performance of the existing international monetary system as disappointing and possibly inferior to what might be achieved by greater fixity of exchange rates and more homogeneity in exchange arrangements. Their concerns have been focused in several areas. First, under floating exchange arrangements, exchange rates have been highly volatile. It is not unusual for key currency exchange rates to move by several percent over the period of a few weeks—a level of variability that is thought by many to be disruptive of international trade and investment. Second, it is often asserted that nominal and real exchange rates have too frequently been subject to significant misalignments, that is, to situations whereby exchange rates either become divorced from economic fundamentals or reflect inappropriate and unsustainable economic policies. The clearest example of such a misalignment was the appreciation of the U.S. dollar in the early 1980s, but also the movement in the opposite direction in the early 1990s—leading to questions about the ability of private capital markets to respond to events in a manner that reflects economic fundamentals.

As the main features of the international monetary system, as well as proposals for reform, have been dealt with at length elsewhere, this paper provides a selective discussion of the issues involved. Section II gives a brief overview of the key characteristics of the current exchange rate regime. This is followed in Section III by a summary of the evolution of international capital markets since the collapse of the Bretton Woods system. Possible defects in the current international monetary system—excessive exchange rate volatility, proclivity to misalignment, and abrupt changes in access to international capital markets—are then examined in Section IV. Some approaches to dealing with these possible deficiencies are discussed in Section V, and the final section—Section VI—presents the paper's conclusions, including implications for the role of the IMF.

A central issue discussed in this paper is the extent to which fundamental reform of the international monetary system is feasible or desirable at present. In this paper, "fundamental reform" refers to a systematic and sustained effort on the part of the three major industrial countries to maintain their exchange rates within agreed ranges. The staff of the IMF has for some time set forth views on this topic based on extensive analysis of the operation of the international monetary system. This paper summarizes those views in an effort to prompt a debate, with the recognition that other serious schools of thought are more sympathetic to the need for, and prospect of, fundamental reform. It is hoped that this debate will help to delineate areas of agreement and of disagreement and to contribute to an understanding of the measures that might be taken to improve the performance of the international monetary system, whether or not these measures might be characterized as “fundamental reform.”

With regard to the feasibility of fundamental reform, the key question is whether the three largest countries are prepared to assign to monetary policy the primary task of keeping their exchange rates within relatively narrow ranges. (The use of other policies for this task is discussed below.) In their policy choices to date, the authorities in these countries appear to have demonstrated a clear preference for using monetary policy primarily for the purpose of domestic stabilization, that is, for pursuing the ultimate objectives of sustainable growth with low inflation. Moreover, it seems unlikely that a new European Central Bank, charged with the mandate of pursuing price stability in the European Union (EU), would want to compromise this objective by taking on ambitious exchange rate objectives vis-à-vis the other two major (non-Union, non-European) currencies.

Although, owing to its flexibility and effectiveness, monetary policy is the most potent instrument for achieving exchange rate objectives, the question arises as to whether other available policy instruments could substitute reliably for monetary policy in pursuing this external assignment. Fiscal policy is not generally suitable for this task; it is too inflexible, it should not be deflected from its appropriate medium-term objectives, and it has too uncertain a relationship to exchange rates to be relied.

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1 See Musa (1990) for a discussion of this increase in volatility.
3 For an extensive discussion of the integration of national capital markets, see Goldstein and Musa (1993).
4 See International Monetary Fund (1984b, 1984c); Crockett and Goldstein (1987); Aghevli, Khan, and Montiel (1991); Frenkel, Goldstein, and Masson (1991); and Goldstein and others (1992).
Sterilized exchange market intervention may be useful for helping to calm disorderly markets, and even, on occasion, for sending signals to the markets about policy intentions and exchange rate objectives. However, it is simply not potent enough in today's world of enormous and agile private international capital flows to manage exchange rates on its own when the markets have a concerted and determined view that a prevailing exchange rate is not sustainable. Finally, controls on international capital flows run counter to the efficient allocation of global saving and are unlikely to be effective in influencing exchange rates unless implemented on a near universal basis—a most unlikely outcome. Recall, for example, that two of the world's six largest exchange markets (Hong Kong and Singapore) are located outside the Group of Ten countries.

With regard to the desirability of seeking fundamental reform of the international monetary system at present, a number of considerations are relevant. First, if exchange rate management were given top priority by the three largest industrial countries in the orientation of monetary policy, there could well be costs in terms of their ability to achieve sustainable growth with low inflation. Given the cyclical differences among these countries and the country-specific shocks affecting them in recent years, significant external constraints on the conduct of monetary policy could well have been counterproductive in terms of the ultimate goals of that policy. Nor is it clear that the benefits to the rest of the world from increased exchange rate stability in the major currencies would outweigh the costs created by the reduced possibilities to stabilize output and inflation in these countries. Second, the present system already allows those countries for which exchange rate stability takes on particularly high importance to participate in regional arrangements that limit the degree of exchange rate variability. Third, there is ample scope within the present exchange rate system for fostering conditions more favorable to greater exchange rate stability. Specifically, improvements in the design and implementation of domestic economic policies—particularly in the fiscal and structural areas—are the most viable and effective means for alleviating the symptoms of poor systemic performance.

It is particularly in this third area that the IMF has an important role to play in improving the functioning of the present system. In many respects, this system, with its diverse exchange arrangements and immense stocks of mobile capital, makes surveillance by the IMF even more challenging than during the Bretton Woods system of pegged rates and limited capital flows. While the increased size and mobility of private capital has meant that private market surveillance of errant economic policies is now a more potent instrument than before, experience suggests that market discipline does not always occur at an early enough stage. Therefore, strengthened IMF surveillance can make an important contribution by encouraging the timely implementation of underlying policy adjustments—before private market participants force these adjustments to be made on a more costly basis. In this connection, it is relevant to note that neither pegged exchange arrangements nor floating rates have proved completely successful over the past decade or so in disciplining errant fiscal or structural policies. In a similar vein, there is room for increasing the IMF's role as the main forum for international monetary cooperation, so that episodes of exchange rate behavior unrelated to economic fundamentals—or other specific exchange rate policy issues—can be discussed and evaluated, thereby helping to bring about cooperative solutions.

The route to effective reform of the international monetary system does not lie in attempts to directly impose greater exchange rate stability. Rather, the key to achieving this objective—which should not be seen as an end in itself, in part because equilibrium real exchange rates can and do change over time—is provided by improvements in national policies fostered by international cooperation. IMF surveillance should focus on getting the domestic fundamentals right, including monetary policy aiming at price stability, fiscal discipline, and structural policies that promote the efficient working of labor and other markets. Better policies will, in turn, be conducive to the convergence of economic performance in the form of low inflation, higher saving, and improved growth performance on a sustained basis. The cooperative and coordinated pursuit of these objectives through IMF surveillance will thereby tend both to encourage greater exchange stability for those currencies that are floating and minimize exchange market crises and pressures for currencies that are pegged.