EXTRA

THE INTERNATIONAL MONETARY SYSTEM: KEY ISSUES

Background Paper

for remarks by

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at the

33rd International Banking Summer School

Banff, Alberta

September 1st, 1980

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INTRODUCTION

In examining the key issues facing the international monetary system as we begin the 1980s, it may be useful first to take some account of the nature of the major problems in the world economy today. The most basic of these problems stem more from real, that is to say physical, causes than from financial causes. The plight of the poorer countries of the world reflects to a large extent the scarcity of real resources relative to population in many areas. Even in the case of those difficulties generally attributed to the sharp rise in the price of oil in recent years the fundamental problem is a real not a financial one: the world is running short of readily accessible supplies of energy from conventional sources. Although it follows that these real resource problems cannot be solved merely by international arrangements for making payments and allocating credit, no matter how efficient they are, a well-functioning international monetary system can make an important contribution in coping with the financial aspects of these problems and thus facilitating the development and transfer of real resources.

Perhaps I should make it clear at the outset that I do not regard reform of the international monetary system as a key issue at this time. Even though the present set of international monetary arrangements can hardly be described as a complete and coherent system, particularly in the sense of one that includes uniform standards for the behaviour of all countries, I see no sign that we can expect much of a movement in that direction. Rather, any evolution of our present arrangements is more likely to be guided by pragmatism rather than by principle. In other words, the main task in the period immediately ahead will be to make what we have work as well as possible.

When the role of the international monetary system is discussed these days attention inevitably focusses on the huge payments imbalances that have arisen from the oil price increases and to some extent from high and varying rates of inflation around the world. The general thrust of this paper is to argue that the international monetary system -- or if we include the private as well as the official banking institutions, the international financial system -- can be expected by and large to function efficiently in recycling funds from surplus countries to those deficit countries that are credit-worthy or, possibly with the help of IMF programs, can be made credit-worthy, but this will not obviate the need for difficult real adjustments. There is a serious danger that in this process the developing countries of the world will bear an especially heavy burden, with consequences not only for the ability of these countries to improve the lot of their people but also for the growth of the world economy.

I express confidence in the capacity of the international financial system to do its part in the job because I am not aware of serious deficiencies in the set of institutions that comprise the system. On the contrary, in recent years it has proven to be remarkably resilient and, although there are pitfalls that must be avoided, I believe it is capable of meeting the demands that in any reasonable view should be placed on it. How well it will perform its role is, nevertheless, a key issue.

Inflation, another very serious problem for the world economy, can be classified as stemming more from financial than from real causes, although recently the problem has been exacerbated by the oil price increases. For some, a key issue for the international monetary system is whether its institutional arrangements can make an important contribution towards controlling inflation by enforcing some degree of discipline on domestic financial policies. Here I believe the prospects of such external discipline having a marked impact are rather limited and that it will be necessary to look mainly to the political will of individual countries to follow appropriate economic policies if inflation is to be controlled.

It may be useful to begin a discussion of the international monetary system with a brief outline of how it has evolved over the last decade or so. I will then go on to discuss the role of banks and financial markets in international lending, touching on the particular problems facing many non-oil developing countries at the present time; and other potential problems in this area. Finally I would like to focus on the interrelated problems of oil price increases and inflation.

RECENT EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

The evolution of the international monetary system since the late 1960s has to only a limited extent reflected deliberately planned changes in the institutional framework; much more pervasive have been the changes that have come about as a result of the pressure of economic forces. For example, it was primarily the wide disparities in economic performance, especially in regard to inflation, among countries who in many cases failed to make appropriate or timely exchange rate adjustments that led to the breakdown in the early 1970s of the Bretton Woods exchange rate system and gave rise to the floating rate system we have today.

Exchange Rate System

The present exchange rate system is clearly much more flexible than the par value system which prevailed for nearly three decades after the Second World War, but other than that it is not easily characterized. A large number of countries, in fact, still peg their currencies to the dollar, to some other currency or to some composite basket of currencies such as the SDR, though this is much less significant than may appear on the surface as the currencies in which the bulk of world trade is conducted are not pegged. Even among those countries whose currencies are not pegged, there is a great variety of exchange arrangements. All members of the European Community other than the United Kingdom participate in the common margin arrangements of the European Monetary System but their currencies float jointly against those of other countries and occasionally currencies are realigned within the system. Certain countries adjust their exchange rates more or less frequently according to a set of indicators or a pre-announced crawling peg. The currencies of most of the others, including the United States, Canada, Japan and the United Kingdom, can be broadly characterized as floating independently.

All of the major trading countries manage their exchange rates to some degree. In recent years many have intervened quite heavily at times in their exchange markets and they have all used other policy instruments to influence their exchange rates. The reasons for this and for the fading away of debate over the merits of "clean" floating relate to actual experience under floating exchange rates.

The evidence of recent years demonstrates that, while the broad movement of floating exchange rates has been in the right direction, the system has tended to encourage too much movement rather than too little as was the case under the earlier pegged system. In practice, exchange rate changes have not typically been gradual over time and, in the short run, they have not necessarily been consistent with divergent economic developments among countries; on the contrary, with the increasing internationalization of capital markets in particular, there has been a tendency for the exchange rates of major currencies to move not only very abruptly but also at times to over-react to changed perceptions of near-term prospects. Such movements can cause unnecessary disruption to the economies of the countries affected. This has led to a wide acceptance of the view that, while letting their exchange rates be influenced by underlying economic forces, monetary authorities need to give short-term exchange rate considerations some weight in their interest-rate strategy and to intervene at times in exchange markets.

A floating rate regime, initially viewed as a temporary expedient, was gradually accepted by the International Monetary Fund and by most of its major members. Concurrently other significant changes were made in the framework within which the Fund functions. Altogether these changes were basic in character and generally such as to meet the need to deal with the evolving realities of the international monetary system. The second amendment of the IMF Articles of Agreement which came into effect in 1978, therefore, involved much more than a formal recognition of a floating exchange rate system.

IMF Surveillance

The most significant of the 1978 amendments to the Articles of Agreement of the IMF was the revision of Article IV. Previously this

Article focussed primarily on the need for countries to promote exchange rate stability and to maintain orderly exchange arrangements. Under the new version, member countries may choose the exchange rate regime best suited to their circumstances. Emphasis is placed on the crucial importance of individual countries following economic and financial policies that contribute to sound economic growth and to a stable international monetary system. Accordingly, this Article provides for a broadening of the scope of Fund surveillance of individual countries' exchange arrangements and economic situations. In exercising this surveillance the Fund holds periodic consultations with member countries and, in evaluating their performance, considers in addition to their exchange rate policy their compliance with the more general obligations of Fund membership, in particular the appropriateness of their economic and financial policies in fostering growth with reasonable price stability.

An important purpose of this emphasis on more general considerations is to strengthen the influence that the Fund can exercise on the economic behaviour of all of its members. It has traditionally been much more difficult for the Fund to impress on surplus countries than on deficit countries the need to take corrective measures when this appears appropriate, since the main incentive that it could bring into play has been access to its lending facilities. Moreover, in a floating rate environment and with the increased role of international capital markets in providing balance of payments support, use of the Fund's lending facilities that involved negotiation of a comprehensive adjustment program has not in many cases been sought as quickly as before by countries with weakening balance of payments positions. The Fund is continuing to work toward strengthening the effectiveness of its surveillance of the economic behaviour of all member countries. It is probably too much to expect, however, that the Fund will ever have as much influence over surplus countries or those with relatively easy access to alternative sources of funds as it has over those countries requiring its financial assistance.

A great deal of consultation about economic policies of the major industrial countries is also undertaken in a variety of other international forums such as the OECD, the EEC, the Bank for International Settlements and more recently Economic Summits. Within the Fund itself, regular meetings of the Interim Committee, the Development Committee and other groups have also provided opportunities for the discussion of broad economic orientations as well as the ongoing developments of the Fund's own policies and practices.

IMF Lending Facilities

The IMF has responded actively to the changing international environment in developing its lending facilities. In the early years of its existence, the concept that the Fund's resources should revolve over a short period dominated the Fund's policy. Drawings under the basic credit tranche facilities were normally made over one year and countries were expected to repay the Fund within three to five years, though several countries had successive stand-by arrangements. In recent years the Fund has introduced greater flexibility in the use of credit tranches, including the possibility of stand-bys that on occasion could extend over periods of up to three years. It has also developed a number of new facilities in response to particular circumstances and to meet the general needs of member countries. The most noteworthy innovations have been the creation of the Extended Fund Facility in 1974, the setting up of the 1974 and 1975 Oil Facilities, the establishment of the Trust Fund financed with profits from the sale of Fund gold and the creation of a U.S. $10 billion Supplementary Financing Facility that became operational in early 1979. In addition, there was an increase in the quotas of members in 1978 and another is in process.

While guidelines are laid down for all drawings from the Fund, a major share of the borrowing in recent years has been under facilities that involve relatively light conditionality, that is to say, without strict performance criteria. The total amount of drawings under upper credit tranches, the Extended Fund Facility and the related Supplementary Financing Facility has been relatively small, although a notable increase is in prospect this year. Such drawings are conditional on the adoption of policies appropriate to restore a viable balance of payments position with the stringency of these policies depending on the magnitude of the disequilibrium.

PRIVATE INTERNATIONAL LENDING CHANNELS

The area of the international financial system which is the most important in terms of the magnitude of the flows of funds involved, and where constructive changes also have been taking place, is that of international lending through private channels. The international activities of banks especially have grown extremely rapidly over the last two decades or so and this has contributed a great deal to the ability of countries to deal with the large balance of payments disequilibria generated during this period.

International payments imbalances imply return flows of funds from surplus to deficit areas. But such flows do not occur automatically nor do they generally take place on a bilateral basis; in practice the bulk of the funds generated by balance of payments surpluses have in recent years tended initially to be placed with banking institutions in the major financial centres. These banks on-lend them world-wide in response to normal market criteria. The business of intermediating such surplus funds has contributed to the very rapid expansion of the international deposit and lending activity of banks, a major part of which is done through what are generally referred to as Euro-currency markets. From 1974 to 1979, net international lending to final users increased by close to 25 per cent a year and a further significant volume of funds was raised by borrowers through international bond issues in which international banking institutions also played an important role.

The intermediating role of international banks has on the whole been very useful and indeed necessary in the context of the international balance of payments adjustment process. Very large amounts of funds, which neither international institutions such as the IMF nor national monetary authorities are geared to handle, have been recycled quickly and efficiently. Yet, for reasons on which I will later elaborate and which you as professional bankers will readily grasp, I think it is true to say that the nature of the role banks will play in this area constitutes one of the major challenges that the international financial system will have to face in the 1980s.

THE MAGNITUDE OF THE CURRENT PROBLEM OF PAYMENTS IMBALANCES

Before focussing on the current problems on the international monetary scene, it is perhaps useful to look back briefly and try and see how we have reached the position we are in today.

The oil price shock in 1973-74, coming as it did at a time when unduly expansionary fiscal policies and accommodating monetary policy had contributed to a synchronized boom in the industrial countries and to sharply rising prices for a broad range of basic commodities, undoubtedly added to inflationary problems and reinforced the ensuing recession. However, although inflationary pressures eased with the slowing of growth, rates of inflation generally remained high and, as countries moved to reflate, price performance tended to deteriorate again. This meant that despite the much higher nominal price for oil which prevailed during the 1974-78 period the real price of oil tended to remain unchanged or even decline. As a result, the incentives for long-term changes in the pattern of energy consumption by oil importers were weakened and the terms of trade again moved against the oil exporting countries. At the same time, the absorptive capacity of these countries proved to be much greater than had been anticipated and as a group they experienced a rapid decline in their current account surplus. The mechanisms for recycling funds also turned out to be surprisingly flexible and responsive. Thus, the world economy was able to ride through these years with less difficulty than had at first been anticipated, although there was, of course, a large transfer of real resources to oil producing countries. However, many countries did not adequately tackle the fundamental problems of inflation and of reducing their dependence on imported oil. Although events in Iran were also a contributing factor, this general world environment had much to do with setting the stage for the second oil price shock.

One of the more worrying aspects of the current situation is that, this time, the problem of world payments imbalances does not appear likely to disappear rapidly. Oil exporting countries are likely to resist any erosion in the real price of oil. Moreover, the rate at which the imbalance between oil exporting and oil importing countries will be narrowed depends in no small degree on the success attained by the oil consuming countries in slowing down their demand for oil and in developing alternative energy sources. Even so, although demand by oil producers for imported goods and services will undoubtedly continue to be strong, increased absorption is unlikely to result in a rapid reduction of oil generated surpluses, especially given the concerns of some of these countries about the potentially disruptive impact of overly rapid growth on their economic and social fabric.

According to estimates by the IMF staff, prepared before this summer's further rise in oil prices, the current account surplus of oil exporting countries is expected to increase from about U.S. $5 billion in 1978 to around U.S. $115 billion this year and to remain very large in 1981. The main counterpart to this is a swing in the combined current account position of industrial countries from a surplus of U.S. $13 1/2 billion to a deficit of around U.S. $75 billion this year, with some reduction expected next year, while the deficit of non-oil developing countries may rise from just over U.S. $35 billion in 1978 to nearly U.S. $70 billion this year and increase further in 1981.

The prospective current account deficits of major industrial countries are likely to be financed quite readily. However, the pattern of current account balances can alter rapidly as the very marked changes during the past two years in the position of the United States in one direction and of Germany and Japan in the other have shown. Uncertainties generated by such large swings can become a source of considerable instability in exchange markets. This, together with the tendency for exchange rates to react very sharply at times to shorter term developments, underlines the continuing need for co-operation among central banks of the major countries on exchange market intervention policy.

This year the financing problems of some of the non-oil developing countries have been eased by their ability to draw on fairly comfortable cushions of official reserves and on a large volume of undisbursed bank credit despite substantial disbursement of previously negotiated credit lines in the second half of last year. However, many of these countries have large external debts and rising debt service ratios and the combination of higher prices for oil and other imported goods and of slower growth in their main export markets could well result in a serious deterioration in the position of a growing number of them in 1981. Nor is the outlook in the years immediately beyond 1981 very promising.

Not only are the financing requirements of non-oil developing countries likely to increase sharply over the next few years but the proportion they are likely to be able to finance through private channels may well be significantly smaller. The large remaining gap will have to be closed either by a remarkable increase in lending by official institutions such as the IMF and the World Bank or through other measures, possibly including drastic adjustments in their imports from other countries. Mounting payments arrears are also a possibility.

THE ROLE OF INTERNATIONAL BANKS

Clearly commercial banks will continue to play a major role in the financing of payments deficits, and appropriately so. However, the increased involvement of banks in international lending, the strong competition between them and the prevalence of a borrower's market through much of the period since 1974 has given rise to certain concerns. It can be argued that countries that have been able to borrow fairly readily on capital markets have been tempted to postpone making necessary adjustments, whether on their own or in conjunction with IMF assistance. Their situations may deteriorate to the point where harsher policies will eventually have to be adopted. I recognize that commercial banks, particularly when they are operating with ample liquidity and in a highly competitive market, may not be in a strong position to insist on the sort of conditions to their lending that would encourage borrowing countries to undertake early measures of adjustment. Banks must, however, be fully conscious of the risks involved.

As bankers you will be well aware that the risks in international lending are not the same as those in domestic lending.

Banks have, no doubt, gained valuable experience over the past few years in developing criteria for assessing sovereign risks as well as other risks in international lending. The fact that much of the lending is done under arrangements whereby the interest rate is adjusted at periodic intervals to short-term deposit rates reduces the interest rate risk associated with maturity transformation. At the same time, this feature increases the uncertainty of debt service costs for the borrowers and, in circumstances of rising interest rates, can lead to a rapid escalation of these costs. Banks have, for good reasons, become more concerned about such matters as the external debt situation of borrowers, the degree of concentration in country exposure, the compression of risk differentiation in spreads and the adequacy of their capital; indeed it has been said that under present conditions the equity base of the international banks is the keystone of the international financial system. Recent events have also reinforced concern over potential political problems. A more cautious attitude on the part of banks has been evident in some tightening this year in their lending conditions.

Banks can generally be expected to diversify their assets abroad much as they would their domestic portfolios and they should not be unduly influenced by market share considerations or by pressure from borrowers. So far the record of losses on international lending has been favourable but the risk of future debtor problems has almost certainly been heightened by recent developments and banks could be faced at least with increased rescheduling. It is clear that the prospects for repayment are better in the case of countries that adopt appropriate and timely adjustment measures either on their own or in conjunction with a Fund program. I welcome the ongoing reappraisal by banks of their lending policies in the light of such changing circumstances.

Given the importance of the role of banks in recycling, the magnitude of the international capital flows and their significance for both the world economy and the economies of individual countries, developments in this area are, of course, of considerable interest to the monetary and regulatory authorities. They wish to be assured that appropriate procedures are in place for monitoring and reviewing exposure and concentration of risk and for improving the flow of information to banks through the collection of more comprehensive data. Work has been underway for some years, mainly under the auspices of the Bank for International Settlements, to enhance the quality and dissemination of information on international bank lending and indebtedness. Earlier this year, the central bank Governors of the G-10 countries and Switzerland agreed to improve the methods of assessment of country risk exposure and that each would move toward the reporting by their banks of balance sheet information on an internationally consolidated basis. I am happy to say that this is already the case with reports submitted by the Canadian banks.

While I fully agree with the need for regulatory authorities to ensure that sound prudential standards are maintained, I do not share the view expressed in some quarters that, somehow or other, the rapid growth of international lending of itself leads to an uncontrolled and inflationary growth of the world money supply. By and large the amount of liquid assets, including Euro-deposits, that businesses and individuals are willing to hold at any point in time will depend on the level of their income and wealth and on the level of interest rates on competing assets. As Euro-market rates are closely linked by arbitrage to domestic interest rates on assets denominated in the same currency, the implication is that if the growth of the Euro-market has, in fact, contributed to world inflation, this can only be because domestic interest rates in at least some of the major countries have been too low for considerable periods. Moreover, the Euro-currency market provides very clear benefits. For open economies to function efficiently, substantial elasticity in some area of capital flows is required to offset movements in other parts of the balance of payments. If there were not an efficient international market to facilitate these flows, the interest rate or exchange rate movements necessary to achieve short-run equilibrium could be very large indeed. The value of such a market is, of course, even greater at a time when higher oil prices are increasing the need for an even more efficient recycling mechanism.

AN INCREASED ROLE FOR OFFICIAL INTERNATIONAL INSTITUTIONS

The more cautious attitude recently adopted by banks toward their international lending, while not inappropriate on prudential grounds, does suggest that their contribution to the recycling of the new oil-related deficits may be relatively less significant than it was after the 1973-74 shock. On the other hand, official channels can be expected to play a more important role. Agreement was reached recently on an increase in the capital of the World Bank which, when subscribed, will enable the Bank to borrow more on capital markets to fund the growth in its lending. While such operations do not fall into the category of short-term recycling, they can reduce the size of the recycling job that needs to be done. Currently the IMF is well placed so far as the availability of funds is concerned to provide additional financing and the increase in quotas under the Seventh Quota Review, now in the process of being ratified by member countries, will add further to its resources. However, since in current circumstances it may often be necessary to phase adjustments over a longer period and to provide larger amounts in relation to quotas than has been typical in the past, demands on the Fund's resources may well increase substantially. At the latest meeting of the Interim Committee in April this year, it was agreed that the Managing Director be encouraged to "start discussions with potential lenders on the terms and conditions under which the Fund could borrow funds to increase its resources, if and when the need arises".

Like other lenders, the Fund has to be concerned with the ability of borrowing countries to repay. It is aware that some countries have regarded its conditions as being unduly onerous and is endeavouring to encourage countries facing difficulties to adopt corrective measures supported by use of its resources at an earlier stage. This is one of the purposes of the consultation and surveillance process to which I referred earlier. Last year the guidelines on conditionality were reviewed with the intention of ensuring that lending policies are appropriately flexible and reflect an awareness of the particular circumstances of a country. Banks may well find that it is in their own long-run interest to encourage countries in difficulty to turn to the Fund earlier and generally structure their lending policies to support the Fund's role in the adjustment process. This role is crucial because of the Fund's unique ability to exert an influence on the policies of both developed and developing countries. For its part, the Fund recognizes that the commercial banks still have a major role to play in the financing of payments imbalances and hence welcomes the closest co-operation that is consistent with the somewhat different responsibilities of the Fund and of banks.

OFFICIAL INTERNATIONAL RESERVE ASSETS

Another area of concern to the Fund and to others has to do with the implications of a multi-currency reserve system. Although the U.S. dollar remains by far the most important reserve currency, there has been some move towards portfolio diversification of reserve holdings -- particularly on the part of monetary authorities outside the major industrial countries -- into assets denominated in other currencies such as the Deutschemark, Swiss franc and yen. This has been viewed as having a potentially destabilizing effect on exchange markets.

This was one of the reasons behind the recent proposal for a Currency Substitution Account, whereby participants could deposit some of their U.S. dollar holdings in exchange for SDR-denominated claims on an account managed by the IMF. The objective was to offer official reserve holders an asset subject to less exchange risk than that on any single currency and one on which they would earn a reasonably attractive return. In the event, it has not proved possible to reach agreement on the key arrangements for maintenance of value in the Account. More recently there appears to be a lessening of concern about the development of multi-currency reserves. This is at least partly due to the shift in the balance of payments positions on current account of some of the major countries from surplus to deficit: countries that have deficits to finance tend to be less concerned about capital inflows resulting in investments that are regarded as reserve assets by other countries.

THE POTENTIAL PROBLEM FOR NON-OIL DEVELOPING COUNTRIES

As the time I have devoted to discussing the question indicates, the capacity of private markets and official financial institutions to recycle funds to credit-worthy borrowers is a matter of immediate and practical interest. But a more pressing problem may well be the inability of many countries to qualify as credit-worthy because of the sheer burden that deficits of the size foreseen over the next few years may well place on an increasing number of non-oil developing countries in relation to their economic prospects. This does not mean that developing countries do not need to tackle problems of domestic inflation and of adjustment to the changed energy situation. In fact, over-reliance on external financing, even if readily available, could lead to delays in making the necessary adjustments and could compound longer term problems.

Uncollectible loans, whether provided by private or official institutions, would not represent an acceptable solution to the problems faced by non-oil developing countries. What some of them mainly need are grants, not loans, but in the present state of the world a substantial increase in aid flows does not, unfortunately, seem likely. If non-oil developing countries are forced to constrain demand severely, there will be an impact on their economies, which for many of the poorer countries could be extremely difficult in social as well as economic terms, and such a development could also constitute a drag on the world economy.

It is essential that this should be recognized and that every effort be made not only to increase unilateral transfers but to avoid putting barriers in the way of non-oil developing countries increasing their export earnings to pay for imports. A number of developing countries have been remarkably successful in recent years in achieving high rates of growth in part based on the export of manufactured goods. This has added to the problem of adjustment in some of the older industrialized countries and given rise to pressures for increased protection of domestic industries. However, continued strong growth of these developing countries also provides market opportunities, particularly in high technology areas. Protection can only inhibit long-run changes to domestic and international trade patterns that are required to maintain a strong world economy and more efficient and dynamic national economies.

OIL PRICES AND THE CONTROL OF INFLATION

I would like to conclude by returning to what I regard as the important issues facing the industrial countries. A healthy world economy and the smooth functioning of the international payments system will only be achieved if the underlying causes of payments imbalances and inflation are dealt with in the major industrial countries.

Unquestionably, the increased price of oil is contributing to inflation but it is widely agreed -- and this is a more realistic view than had prevailed earlier -- that a higher relative price must in time be accepted. There is considerable scope for more efficient use of energy, especially by industrial countries, and in this respect there is evidence of a substantial response to higher energy prices, at least over the medium term. At the same time it is important that energy policies should be framed so as to encourage over the medium term the investment required to improve energy efficiency and develop alternative sources, and thereby reduce dependence on imported oil. But it is most important that while accepting necessary changes in the relative price of energy we control carefully the over-all rate of inflation. As was pointed out by the Managing Director of the IMF in a recent speech, "this necessary domestic adjustment in the real prices of petroleum will not be achieved or produce structural changes if higher energy prices are allowed to trigger parallel increases in the general level of prices and in wages. The fight against inflation is thus at the root of an effective energy policy".

On the encouraging side it does appear that we have learned something from recent experience. The experience of the 1970s has brought home to the authorities of many countries the seriousness of the inflationary problem and the need to persevere in policies to combat it. This has been reflected in part in a heightened focus on controlling growth in the money supply and several countries are framing monetary policy around announced targets for growth in monetary aggregates. As a result, the policy reaction to the second oil price shock has differed somewhat from the previous one. In contrast to the mid-1970s, when there was considerable concern about the deflationary impact on demand

and output, the emphasis this time in most major countries continues to be placed on the need to combat inflation as a prerequisite to sustained growth, even at the risk in the near term of a temporary slowing of economic activity. Reflecting this, monetary policy in most industrial countries has generally been firm during the past year and in some countries the stance of fiscal policy has also firmed.

Unfortunately, progress towards the goal of reducing inflation is complicated by the extent to which inflationary expectations have become entrenched. There has been a widespread worsening of inflation throughout the world during the past year and a half, but what is even more discouraging is that an acceleration was evident in the industrial countries in early 1979, before the sharp upward movement of oil prices. In fact, if one looks back over the past twenty-five years, it is clear that the basic trend in the world economy has been towards higher inflation. There can be little doubt that the primary reason for this was the attempt by most countries in the conduct of their policies to achieve and maintain higher levels of output and employment than was consistent with price stability. As a result people have learned to expect inflation and to discount public promises that it will be reduced. It would be a mistake to underestimate the difficulties of turning these expectations around. I am convinced that an absolutely essential element in bringing inflation under control is to keep the rate of monetary expansion within reasonable limits. But I also want to emphasize that monetary policy is a financial instrument and it operates directly on financial flows in an economy. The way in which real economic variables -- employment, productivity and output -- in the economy respond to changes in financial flows is heavily dependent not only on the state of inflationary expectations but also on other policies and practices throughout the economy. If the goal of reducing inflation is to be achieved efficiently, an appropriate monetary policy must also be accompanied by modifications of various policies and practices -- both in the public and the private sectors -- that contribute to inflation.

So far as the international monetary system is concerned, I doubt that it is now, or ever was for that matter, reasonable to expect any variant of the system to enforce sufficient discipline on countries to ensure that they will always eschew inflationary "solutions" to their economic problems. It is inevitable that national sovereignty will play an important role in this matter. Even under the old gold standard, which had its own difficulties, the discipline it offered could under pressure be escaped by suspending the convertibility of domestic currency into gold or by altering the required ratio of gold reserves to domestic currency. Under the Bretton Woods system of fixed exchange rates it was possible, and indeed if inflationary policies were followed long enough it became absolutely necessary, for a country to devalue its currency. Today we can expect the International Monetary Fund to do its best to encourage the pursuit of responsible economic policies, but in the end the responsibility must lie, as it really always has, with individual countries. Countries that succeed in avoiding serious inflation may by their example exert a positive influence on others. What we should be able to rely on most of all by now is the accumulated evidence that so far as economic progress is concerned inflationary policies are a dead end.

Ottawa
July 31, 1980