THE NEED FOR ORDER IN INTERNATIONAL FINANCE

Address by

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I plan to comment tonight on the need for order in international finance. My choice of topic does not require lengthy justification. For more than a decade now, we have been besieged by problem after problem in the working of international financial mechanisms. Strain and turbulence have, in fact, been so constant a feature of the international financial scene in recent years that I suspect they are coming to be widely regarded as the normal state of affairs.

I do not share any such mood of resignation. In the first place, governments around the world now have a better understanding of the troubles caused by inflation—both in their own economies and in international dealings—than they had only a few years ago. As a result, not a few countries have been adjusting their economic policies with a view to curbing inflation. In the second place, financial institutions—particularly commercial banks—are now giving closer attention to the volume and character of their foreign lending. And in the third place, the International Monetary Fund has been gaining in prestige and is already exercising a more constructive influence than seemed likely a year or two ago. These are promising trends, and if we build on them we can in time reattain the financial stability that is so vital to orderly expansion of the international economy.

Certainly, we all know of the great difficulties that plagued financial relationships among countries during the 1930's. Those difficulties generated pessimism about the capacity of nations ever again to achieve orderly arrangements for the conduct of international finances. And that pessimism was deepened by the frightful disruption of the world economy during the war. Yet, it was the genius of that age to devise the structure of Bretton Woods and to strengthen that extraordinary structure with our own Marshall Plan. Within a framework of established financial rules, a great liberalization of the world economy occurred and world trade and output flourished. Although we tend to forget it now, the postwar period was a time of quite impressive stability in world finance until the early sixties.

That experience should serve to remind us that difficulties do yield to determined effort. Our present problems in the sphere of international finance, while different from those of a generation ago, surely are no greater. They too can be dealt with effectively if once again we perceive the wisdom of some subordination of parochial interests and if nations marshal the will to live by new rules of responsible behavior.

Quite obviously, the overriding problem confronting us in world financial matters today is the massive and stubborn imbalance that prevails in payments relations among nations—a condition arising importantly, although by no means exclusively, from OPEC's action in raising the price of oil so abruptly and so steeply.

This year alone OPEC's revenues from international oil sales are likely to total something on the order of $130 billion. What is most significant about that figure is that it represents an enormous explosion of revenues in such a short time. In 1972, before OPEC's aggressive pricing policy began, receipts of the OPEC group from international oil sales totaled less than $14 billion, with most of the rise since then representing higher prices rather than enlarged volume. For the great majority of OPEC's customers—both affluent and needy alike—it has been the rapidity of the massive change that has been so troublesome. To be sure, OPEC members have dispensed some aid to less developed countries, but so far the grants have been very selective and quite small relative to the size of the international problem that OPEC has created.

The imposition of the enormous tax that the OPEC group has in effect levied on the world economy has been met, as you know, partly by transferring goods and services to OPEC members and partly by deferring such transfers through borrowing arrangements. OPEC's absorption of goods and services for both consumption and development purposes has been expanding, with the consequence that OPEC's collective current-account surplus has shrunk considerably from its peak level of more than $65 billion in 1974. Only five of the thirteen OPEC nations in fact are currently running sizable payments surpluses. Contrary, however, to earlier widespread hopes that the aggregate OPEC surplus would continue to decline—perhaps nearing elimination by the end of this decade—it seems at present to be eroding slowly, if at all. This year it could easily run above $40 billion, marking the fourth consecutive year that OPEC's trading partners as a group will have to seek substantial loans or grants to help meet their oil bills.

Continuation of a surplus for the OPEC group at such a high-level reflects several influences: first, the further increase that occurred this January in OPEC oil prices; second, growing demand for oil as recovery of the world economy has proceeded; third, insufficient energy conservation by many non-OPEC countries, including most notably the United States; and fourth, a slowing of import absorption by the OPEC group—in some instances because bottleneck problems of one kind or another are being encountered, in other instances because development plans have come to be viewed as excessively ambitious. The apparent stickiness of the OPEC payments surplus at a high level, buttressed by what is now a significant stream of income from investments, implies large-scale financing requirements for OPEC customers for a considerable period ahead. The prospect of such persistent financing needs, year after year, is especially worrisome.

Great as must be our attention to these OPEC-related problems, we dare not lose sight of the fact that our international payments mechanism is now under stress for reasons that go beyond the extraordinarily high price of oil. The payments deficits of various nations, both industrial and less developed, can be traced to extensive social-welfare and development programs undertaken in the early 1970's and financed by heavy governmental borrowing, often directly from central banks. Even when the internal stresses resulting from inflation were aggravated by the oil burden and by weaker exports, there was little or no adjustment of economic policies in numerous instances, thus causing external positions to deteriorate sharply. There were conspicuous exceptions, of course, particularly on the part of countries that historically have the greatest sensitivity either to inflation or payments imbalance, or both. A wide diversity of payments imbalances thus developed around the globe, accentuated for a time by differences in the severity with which recession affected national economies and, more recently, by differing inflation and recovery trends.

The current pattern of international payments imbalances, in short, is something far more complex than an OPEC phenomenon alone. Essentially, what prevails is a problem within a problem. First, the non-OPEC group of countries collectively has a massive structural deficit vis-a-vis OPEC. In addition, serious payments imbalances exist within the non-OPEC sector itself, with a few nations experiencing sizable surpluses on their current account while many others suffer deficits that reflect many factors besides the way in which the burden of costly oil imports happens to be distributed around the globe.

A great deal of effort has been devoted by scholars to the task of trying to estimate how long the present severe imbalance of international payments accounts could persist in the absence of deliberate new policy actions. The results of these exercises generally are not reassuring. They point to the distinct possibility that huge borrowing needs—that is, needs that are uncomfortably large in relation to the debt-servicing capabilities of many countries—could persist at least through the remainder of this decade.

The potential trouble in this set of circumstances should be obvious. If OPEC surpluses on current account should continue on anything like the present scale, they would inevitably be matched by deficits of identical magnitude on the part of other nations. And if some countries outside OPEC should also have sizable and persistent surpluses, as now appears to be the case, the aggregate deficit of the remaining countries will be still larger. Under such circumstances, many countries will be forced to borrow heavily, and lending institutions may well be tempted to extend credit more generously than is prudent. A major risk in all this is that it would render the international credit structure especially vulnerable in the event that the world economy were again to experience recession on the scale of the one from which we are now emerging.

To minimize the risks that face us, there is a clear need for a strong effort involving all major parties at interest. In order to achieve relatively smooth expansion of the world economy, five conditions are essential: first, the aggregate of payments imbalances

around the world needs to be reduced far more rapidly than currently observable trends imply; second, the divergences that now exist among countries with regard to their balance-of-payment status need to be narrowed; third, protectionism must be scrupulously avoided by governments; fourth, private financial institutions need to adhere to high standards of creditworthiness in providing whatever volume of international financing occurs during the next few years; and fifth, official credit facilities need to be significantly enlarged.

The realization of these conditions requires diligent pursuit of stabilization policies by countries that have been borrowing heavily in international markets. The obstacles to speedy adjustment on the part of these countries are well known. Resistance stems chiefly from the political difficulty of gaining broad acceptance of the painful things that must be done to restrain inflation and to achieve energy conservation. Countries thus find it more attractive to borrow than to adjust their monetary and fiscal policies; and if they can do this without having lenders write restrictive covenants into loan agreements, so much the better. That is why countries typically prefer to tap foreign credit markets to the maximum extent possible rather than borrow from the International Monetary Fund which, in aiding countries that experience significant payments disequilibrium, makes credit available only after the borrower has agreed to follow internal policies judged appropriate by the Fund. Commercial banks, as a practical matter, have neither the inclination nor the leverage to impose restrictive covenants on sovereign governments.

In these circumstances, admonition alone is likely to accomplish little in prodding countries with large payments deficits to take affirmative action. There are, however, limits dictated by financial prudence beyond which private lenders will be unwilling to go. More than one country has recently found that its ability to borrow in the private market has diminished. The fact is that commercial banks generally, and particularly those which have already made extensive loans abroad, are now evaluating country risks more closely and more methodically. Credit standards thus appear to be firming; and as information about borrowing countries improves, we can reasonably expect the market to perform its function of credit allocation more effectively.

As some of you may know, the Federal Reserve is currently engaged in a joint project with other central banks to obtain a much more complete size and maturity profile of bank credit extended to foreign borrowers, country by country. That information, which is being gathered under the auspices of the Bank for International Settlements, will be shared with private lenders, but even so it will fill only a fraction of the existing informational gap.

What we need is a more forthcoming attitude on the part of borrowing countries in regularly supplying information to lenders on the full range of economic and financial matters relevant to creditworthiness. I realize that much of the needed information is not even collected in some countries, but such a condition should not be tolerated indefinitely. Logically, the BIS—having links with the central banks of the principal lending countries—could take the lead in setting forth a list of informational items that all countries borrowing in the international market would be expected to make available to present or prospective lenders. Compliance could then become a significant factor in the ability of countries to secure private credit, particularly if—as I would judge essential—bank regulators in the various lending countries explicitly took account of compliance in their review of bank loan portfolios.

Imperfect or incomplete information, as I think we all recognize, makes for inefficient markets and heightens the risk of disruptive discontinuities if some previously unknown but pertinent fact suddenly comes to light. In the market for bank credit, a continuous flow of factual information will produce gradual as distinct from abrupt changes in assessments of creditworthiness. This should induce earlier recourse to the IMF by countries experiencing payments difficulties than was usually the case in the past. Even now, as lenders are becoming better informed and somewhat more cautious in extending foreign credit, a tendency toward earlier recourse to the IMF appears to be emerging. It seems likely, therefore, that more countries that need to adjust their economic policies will henceforth do so sooner and probably also more effectively. By so doing, the unhappy alternative of resorting to protectionism will be more readily avoided.

Private banks—both in this country and elsewhere—played a very substantial role in "recycling" petrodollars between the OPEC group and other countries, especially those whose external payments position was weakened by the higher oil prices. Had the banks not done so, the recent recession would have been more severe than it was, since there was no official mechanism in place that could have coped with recycling of funds on the vast scale that became necessary in 1974. But with many countries now heavily burdened with debt, bankers generally recognize that prudence demands moderation on their part in providing additional financing for countries in deficit. For that reason, they understandably wish

to see an increase in the relative volume of official financial support to countries that continue to have large borrowing needs.

Bankers are not alone in wanting to see countries in deficit pursue adjustment policies more diligently. This interest, in fact, is widely shared by economists and other thoughtful citizens who see an urgent need for healthier and more prosperous economic conditions around the world. The interests of the international economy and of private lenders thus converge and point to the need for a much more active role by the Fund.

The leverage of the Fund in speeding the process of adjustment would clearly be enhanced if its capacity to lend were greater than it is now. One reason why countries often are unwilling to submit to conditions imposed by the IMF is that the amount of credit available to them through the Fund's regular channels—as determined by established quotas—is in many instances small relative to their structural payments imbalance. That will be so even after the scheduled increase in IMF quotas becomes effective. To remedy this deficiency, the Fund is currently seeking resources of appreciable amount that could be superimposed on the framework of the quota system. Negotiations are in progress with several countries of the OPEC group as well as with the United States and other industrial nations whose payments position is comparatively strong. Such a supplementary Fund facility should induce more deficit countries to submit to Fund discipline. But in no case must it become a substitute for an adequate adjustment policy by borrowers or serve as a bailout for private banks. If negotiations for such a facility are completed soon, which appears possible, high priority should be given to prompt ratification by our Congress and the legislatures of other countries.

The ability of the Fund to act forcefully in speeding the adjustment process will be strengthened in still another way once the five-year effort of amending the IMF's Articles of Agreement is completed. At present the Fund normally immerses itself in urging appropriate policies on a country only when that country applies for financial assistance. Under the revised Articles, the Fund could take the initiative in determining whether individual countries are complying with formally prescribed obligations to foster orderly economic growth and price stability. This authority, once available, will enable the IMF to broaden progressively its oversight role even when a country is not an applicant for a loan.

As the number of countries brought within the reach of the Fund's influence increases—either because of the enticement of enlarged lending facilities or because an IMF "certificate of good standing" becomes essential to further borrowing from private lenders—the outlook for correction of balance-of-payments deficits would be considerably improved. But that outcome will also depend on full appreciation by private lenders of the need to avoid actions that tend to undercut Fund efforts.

This does not mean that Fund judgments are to replace those of private lenders in the determination of which countries should be accommodated with private credit. Nor do I even mean to suggest that the texts of the Fund's country evaluations are to be handed around in the private banking community. Were that to become a practice, I am sure the quality of such reports would suffer by becoming less explicit and less frank. But some sharing of Fund information—within the limits imposed by requirements of confidentiality—may still become feasible, the most logical conduits perhaps being the central banks of the countries in which the major private lending institutions are located.

Fund country reports are transmitted to central banks as a matter of routine, and—as I previously indicated—new factual information about individual countries is now being developed, and more may well be developed later, by the BIS. Private lenders might want to discuss with the staffs of central banks the flow of such information, and this could be done —as would surely be the Federal Reserve's practice —without advising whether or on what scale a loan should be made to this or that country. Such a consultative process, especially if it also involved frequent interchange of information among the leading central banks, would go quite far in preventing any inadvertent circumvention by private banks of the efforts of the IMF to promote financial stability.

The suggestion I am exploring with you for improving the adjustment process obviously will not work unless broadly shared agreement develops that international financial affairs require a "rule of law" to guide us through the troubled circumstances that now exist. Such a rule cannot be codified in detail, but it is essential that there be broad agreement that parochial concerns will be subordinated to the vital objective of working our way back to more stable conditions in international finance. And if the IMF is to play a leadership role in pursuing this objective, it is not only private parties that must avoid weakening the IMF's efforts. Governments also—indeed governments especially—must be prepared to forego their own quite frequent inclination to do things inconsistent with the effective pursuit of Fund objectives. There have been too many instances in which the government of a country negotiating a

stabilization program with the Fund's officials has attempted to circumvent the Fund by seeking instead a loan from another government or by exerting outside political pressure on Fund officials in an effort to make loan conditions as lenient as possible. If the rule of law in international monetary affairs is ultimately to prevail, all countries—there can be no exceptions—must fully respect the IMF's integrity.

Our first requisite, therefore, is for a new sense of commitment by governments as well as private parties to a responsible code of behavior. I believe that understanding of this need has been growing—certainly within our own government. And, of course, the working of the marketplace—tending now to make credit less readily available to some foreign borrowers—is helping to foster a new set of attitudes.

As I noted earlier, the payments difficulties of countries outside the OPEC group reflect many factors besides the way in which the burden of oil costs happens to have been distributed. It is important that adjustment proceed along several paths in this vast part of the world.

First, countries whose external position has been weakened by loose financial policies are going to have to practice some fiscal and monetary restraint, either of their own volition or because they find it obligatory to do so in order to maintain access to international credit facilities, including those of the IMF. In individual instances, the adjustment process in such countries may at times also entail allowing some depreciation of the foreign exchange value of their currencies.

Second, since the burden of adjustment cannot and should not rest with deficit countries alone, those non-OPEC countries that are experiencing significant and persistent current-account surpluses must understand that they too have adjustment obligations. In saying this, I do not mean to imply that we should urge such countries to pursue expansionist policies that could undo or jeopardize the hard-won progress that some of them have made in curbing inflation. That would be both wrong and unwise. What I mean is simply that such countries should not actively resist tendencies toward appreciation in the value of their currencies in foreign-exchange markets. Such appreciation will aid other countries by facilitating access to the markets of the countries in surplus; and at the same time it will make imported goods and services available at a lower cost to the citizens of the surplus countries, thus reinforcing their constructive efforts to control inflation.

Third, practically all non-OPEC countries—the deficit and surplus countries alike—must treat energy conservation as a key element of their economic policy. This is something to which the United States in particular must give the closest attention. We are by far the largest single consumer of energy in the world, and we have so far been notably laggard in addressing the energy problem. This year imported oil will probably account for over 40% of domestic consumption of petroleum, up from 22% in 1970. Our passive approach to energy policy, besides endangering the Nation's future, has aggravated strains in the international financial system, because we are directly responsible for a large part of the OPEC surplus. And, of course, our huge appetite for oil has added to the leverage of those OPEC members that have been most reckless in urging a still higher price of oil. The energy program being prepared by President Carter unquestionably will entail sacrifices by many of our citizens. It is essential, however, that we at long last recognize that a decisive conservation effort must be a major part of our Nation's economic policy.

If, in fact, we can build momentum into payments adjustment by the non-OPEC group of countries along these three paths—that is, internal discipline by countries in deficit, non-resistance to exchange-rate appreciation by countries in surplus, and determined energy conservation by all—the favorable consequences will be enormous. To the extent that energy conservation is effective, the present serious imbalance of the non-OPEC group of nations vis-a-vis OPEC will be reduced. Beyond that, there will no longer be such extremely large differences in the balance-of-payments status of the non-OPEC nations. Consequently, the risk of disruption of the international financial system would be greatly reduced, and we could have greater confidence that progress will be realized around the world in reducing unemployment and otherwise improving economic conditions.

There is a critical proviso, however, to this optimistic assessment—namely, that the OPEC group, seeing their surplus decline as a result of foreign conservation efforts or their own increasing imports, will not seek to compensate for the decline by a new round of oil-price increases. Obviously, if they were to do so—and if they could make the action stick—the whole exercise of trying to reduce the massive payments imbalances traceable to the oil shock would be rendered futile.

Effective oil conservation and the development of other sources of energy would, of course, militate against such an outcome to the extent that those efforts lessened OPEC's market leverage. That is important for the longer run, but particularly in the years immediately ahead it is vital that the members

of OPEC recognize that their economic and political future cannot be divorced from that of the rest of the world. Besides practicing forbearance with regard to the price of oil, it would be very helpful if they made larger grants of assistance to the less developed countries and also expanded the volume of loans and investments made directly abroad—so that the intermediation of American or European commercial banks may be substantially reduced. Fortunately, there are various signs that the more influential members of OPEC are becoming increasingly aware that their self-interest requires a major contribution along these lines. The OPEC group has become a large factor in international finance, and there is some basis for confidence that they will play a constructive role in the reestablishment of order in the international financial structure.

In the course of my remarks tonight, I have touched on a number of actions that either need to be taken or avoided to achieve a new sense of order in international finance. Let me conclude by sketching or restating the responsibilities, as I see them, of the major participants in the international financial system:

First, in order to contribute to a more stable international system, the IMF must act with new assertiveness in monitoring the economic policies of its members. To give the Fund added leverage for such a role, its resources must be enlarged. But those resources must be used sparingly and dispensed only when applicant countries agree to pursue effective stabilization policies. In view of the clear need for better financial discipline around the world, this would be a poor time for a new allocation of SDR's—or, in plain language, printing up new international money.

Second, national governments must encourage and support the IMF, so that it can become an effective guardian of evolving law in the international monetary sphere. Governments need to resist the temptation to circumvent the Fund by seeking bilateral official loans or to embarrass the Fund by exerting political pressure on Fund officials. Commercial and investment bankers also need to recognize that their actions must not undercut IMF efforts to speed adjustment. The IMF, in its turn, will have to equip itself to handle appropriately its new and larger responsibilities.

Third, a better framework of knowledge for evaluating the creditworthiness of individual countries is badly needed. Among other things, central banks could work together through the BIS and establish a common list of informational items that borrowing countries will be expected to supply to lenders.

Fourth, commercial and investment bankers need to monitor their foreign lending with great care, and bank examiners need to be alert to excessive concentration of loans in individual countries.

Fifth, protectionist policies need to be shunned by all countries.

Sixth, countries with persistent payments deficits need to adopt effective domestic stabilization policies.

Seventh, non-OPEC countries experiencing large and persistent payments surpluses also need to adjust their economic policies and they can probably best do so by allowing some appreciation of their exchange rates.

Eighth, all countries, and especially the United States, need to adopt stringent oil conservation policies and, wherever possible, speed the development of new energy sources.

Ninth, the members of OPEC must avoid a new round of oil-price increases. They also need to play an increasingly constructive role in assisting the less developed countries and in the evolution of the international financial system.

Observance of these do's and don'ts would go a significant distance, in my judgment, in meeting the formidable challenges that now confront us. But we shall undoubtedly need to be ready to improvise in the fluid and complex area of international finance. I have no illusions that the ideas that I have presented here tonight can serve as a rigid blueprint. I hope, however, that they will have some value in suggesting directions in which governments, private lenders, and official institutions need to move. By working together towards a rule of law in international finance, we shall be contributing to a stable prosperity both for our own citizens and those of our trading partners.