4

Policy Cooperation: The Fund and the Group of Seven

The first purpose of the International Monetary Fund is to "promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems."[1] Surveillance has therefore aimed not only to encourage governments to conduct policies so as to promote their own interests in isolation, taking the policies of other countries as given (as is typically done in Article IV consultations), but also to promote cooperative behavior that will lead to better outcomes for all. In carrying out the latter objective, the Fund has sometimes found itself both in competition and in collaboration with a variety of groups of countries that have come together regularly to deal with monetary problems from their own perspective.

The story of this chapter is how the Fund came to play a significant, if secondary, role when the major industrial countries tried to set up their own internal surveillance over monetary and exchange rate policies in the 1980s. This process had two unavoidable limitations. First, international coordination of economic policies is controversial, not always desirable, and extraordinarily difficult to achieve on a sustained (as opposed to crisis-driven) basis.[2] The major countries reached a series of helpful accords in the second half of the 1980s, but the formal surveillance and coordination exercise largely died out afterward. Second, the Fund participated only at the pleasure of the countries' officials and had no real standing to guide the process. The Fund did promote the strategy, in part by providing an analytical framework and an internationally consistent database. The Managing Director and other senior officials occasionally influenced the direction of the discussions, and they encouraged officials to extend and deepen their commitment to carry out sustainable and internationally consistent policies. For the Fund to play a more central role, or for policy coordination to achieve more lasting results, would have been an unrealistic goal.

Policy coordination in the 1980s emerged from a loose institutional structure developed by shifting coalitions of countries with similar economic interests. The history of industrial country "groups" began in 1961, when the 10 largest countries formed the "Group of Ten" (G-10) to organize and fund the General Arrange-

[1]Article I (i) of the Fund's Articles of Agreement.

[2]For an overview of the issues, see Blommestein (1991) and Cooper (1985). For a sympathetic insider analysis, see Dobson (1991), Chapter 2.

ments to Borrow (GAB).[3] That group was, and remains, officially connected with the Fund through the functioning of the GAB.[4] The smaller groups that emerged later, however, developed more independently of established international agencies. The finance ministers from the inner core of the largest industrial countries began meeting as the "Library Group" in 1973 and quickly became the G-5.[5] Meetings of that group typically were kept highly confidential and low-key, with no communiqués or other public announcements being issued until the mid-1980s. As an outgrowth, the heads of state or government of the seven largest industrial countries began holding annual, highly publicized, economic summit conferences in 1975.[6] From then on, the finance ministers of the G-7 countries met regularly, along with representatives of the heads of government (the "sherpas"), to prepare for the annual summit conferences, while those in the G-5 would meet separately—at least twice each year, in conjunction with the spring and fall Fund-Bank meetings—to discuss monetary issues.

Among the much larger and more diffuse circle of developing countries, the formation of small action or discussion groups was more difficult. At the original United Nations Conference on Trade and Development (UNCTAD), held in Geneva in March 1964, 77 developing countries decided to form the G-77, a loose coalition aimed at discussing issues of mutual interest on international trade policy. (Eventually, the membership of the G-77 exceeded 100 countries.) Then in November 1971, as a counterweight to the role that the G-10 was seeking to play in

[3]The G-10 originally comprised the United States, Japan, Germany, France, and the United Kingdom (which later would constitute the G-5); Italy and Canada (which, together with the G-5, would become known as the G-7); plus Belgium, the Netherlands, and Sweden. From 1964, Switzerland was affiliated with the G-10 through a related agreement with the Fund, and its role was formalized when it joined the GAB in 1984. On the changing role of the G-10 in the 1970s, see de Vries (1985), pp. 143–53.

[4]The G-10 countries also have a role within the Organization for Economic Cooperation and Development (OECD), as their membership is similar to that of Working Party 3 of the OECD's Economic Policy Committee; and within the Bank for International Settlements (BIS), where the central bank governors of the G-10 countries meet on a monthly basis. For the more recent history of the GAB, see Chapter 17.

[5]Prior to the second meeting of the Committee of Twenty in 1973, U.S. Treasury Secretary George Shultz invited his counterparts from Germany, France, and the United Kingdom to an informal gathering at the White House library on March 25 to discuss options for responding to the crisis in exchange markets. The group met again at the Annual Meetings in Nairobi that September. The finance minister from Japan was also invited, at Shultz's request, and the meeting was held at the residence of the Japanese ambassador to Kenya. From then on, that group of countries informally constituted the G-5. See Shultz (1993), pp. 147–48; and Volcker and Gyohten (1992), pp. 126 and 134.

[6]See Gold (1988) for the historical relationships between the G-5 and the IMF. As Gold notes, two of the heads of state at the first economic summit—Helmut Schmidt (Germany) and the host of the meeting, Valéry Giscard d'Estaing (France)—had previously participated in G-5 meetings while serving as finance ministers and "were eager to recreate those meetings, but at the highest level" (p. 107). The six original summit countries, represented at Rambouillet, France, in November 1975, comprised the G-5 plus Italy. Subsequent summits (starting with the meeting in Puerto Rico in June 1976) also included Canada, which thus rounded out what became known as the Group of Seven. Starting in 1977, the Commission of the European Communities also participated in the G-7 summit conferences.

guiding the discussions on the reform of the international monetary system, a smaller group of developing countries formed the Intergovernmental Group of Twenty-Four on International Monetary Affairs, or the G-24. (See map, Figure 4.1.) With a technical secretariat provided mainly by the United Nations, the G-24 played an increasingly important role in discussions of international financial issues.[7] Nonetheless, because of the diversity of interests among the member countries of the G-24 and because of the group's relatively weak economic power, its influence in the 1970s and 1980s was quite limited compared with any of the industrial country groups.[8]

From the beginning, the discussions at the G-7 summits dealt directly or indirectly with issues pertinent to the IMF. That pattern began with a bang at Rambouillet in 1975, when the summit ratified the Franco-American agreement on stabilizing the exchange rate system by amending the Fund's Articles of Agreement and mandating firm surveillance (de Vries, 1985, pp. 746–47). The 1976 summit, in San Juan, Puerto Rico, was more low-key and did not lead to any new initiatives. It did, however, obliquely endorse the Fund's new oil and extended financing facilities and the possibility of mobilizing the GAB if needed to support Fund loans to Italy or the United Kingdom. In 1977, at a time when the Fund was deepening its involvement in persuading countries to adopt more liberal trade policies, the summit in London "strongly endorsed" the expansion of IMF quotas and other resources, linked to conditional lending, as an important means of helping countries avoid taking refuge in protectionism.[9] And in 1978, shortly after the Fund had joined the push for a coordinated strategy to restore world economic growth, both in the World Economic Outlook (WEO) exercise and in Article IV consultations with the major countries, the Bonn summit endorsed the strategy and won the agreement of the German authorities to shift to a more expansionary fiscal policy.[10]

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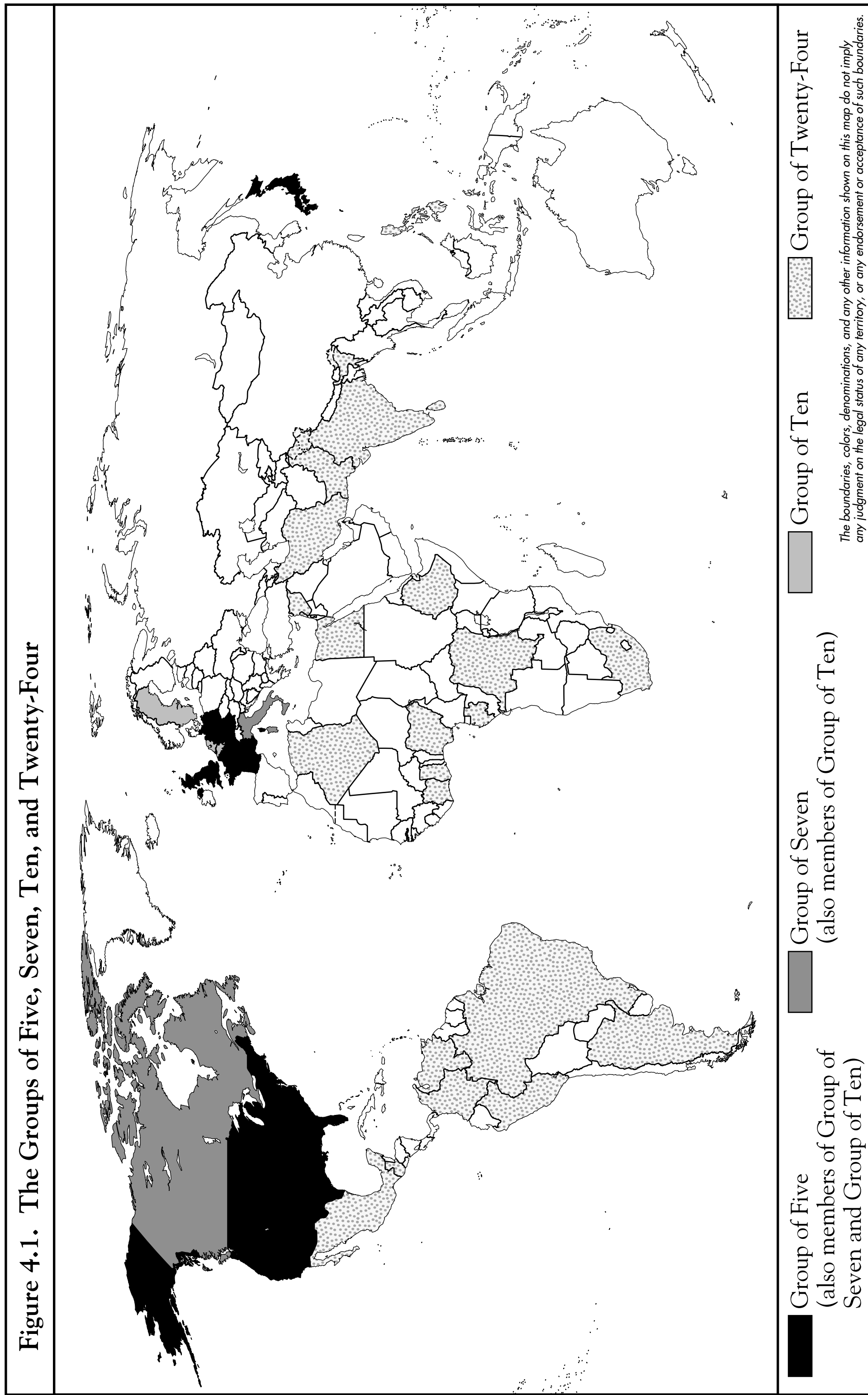
[7]The G-24 secretariat was headed from 1975 through 1990 by Sidney Dell, a senior official of the United Nations Development Programme (UNDP). Subsequently, Professor Gerald K. Helleiner of the University of Toronto became the Research Coordinator for the G-24, with funding from UNCTAD and a number of governments of industrial and developing countries. On occasion, the staff of the IMF assisted both the G-24 and the various industrial country groups with specific research projects. For an overview on the evolution and role of the G-24, see Mayobre (1999).

[8]Perhaps the most successful muscle-flexing by the G-24 occurred at the October 1994 meeting of the Interim Committee, when the developing country members of the Committee blocked an industrial country proposal for an allocation of SDRs to relatively new members of the Fund in order to gain leverage for a general allocation to all members.

[9]All of the communiqués through 1989, with some background documents, are compiled in Hajnal (1989). Those and later documents are also available through a website at the University of Toronto, www.g7.utoronto.ca. Hajnal (1999) gives an overview of the G-7 process and its documentation. For a critical analysis of the meaning of the communiqués, see von Furstenberg and Daniels (1992).

[10]The staff view that "there is now a need for greater emphasis on policies to stimulate economic growth" received "wide support" from Executive Directors in the WEO discussions of April 1978. See "World Economic Outlook—General Survey," ID/78/1 (April 3, 1978), p. 33; minutes of IS/78/6 (April 18, 1978), p. 11; and de Vries (1985), pp. 795–96. The Fund's position in the 1978 consultations with Germany is discussed above, in Chapter 3. The main forum for the initial development of the coordinated reflationary strategy was the OECD in Paris; see McCracken and others (1977).

Figure 4.1. The Groups of Five, Seven, Ten, and Twenty-Four



The 1979 G-7 summit, held in Tokyo, dealt primarily with the large increases in petroleum prices that were then under way: an issue that was also the main focus of the WEO that year (see Chapter 5). The resulting policy shift toward control of inflation, which was manifest initially at the Annual Meetings in Belgrade in October 1979, was formally endorsed by the G-7 at the 1980 summit in Venice. The following year, in Ottawa, the G-7 leaders regretted the persistence of high real interest rates in the United States,[11] again striking an accord with positions taken by the Fund both in the consultations and in the WEO. Up to this point, the linkages between the Fund and the G-7 were both arm's length and coincidental, in the sense that the policy positions were for the most part independent responses to the same developments in the world economy. That relationship began to shift toward one of closer cooperation in 1982.

"In His Personal Capacity": 1982–84

In the spring of 1982, the functioning of the international monetary system was beginning to reemerge as a priority at international meetings. The tight financial policies that most industrial countries had been implementing for two years or more had succeeded in bringing down inflation rates, but the persistence of those policies had prolonged the weakness in output growth and had kept interest rates near record levels in real terms. The problem therefore was to plan the timing and extent of a monetary relaxation so as to rekindle growth without fanning the inflationary flames. Meanwhile, the U.S. dollar had been appreciating against most other key currencies for nearly two years, and concerns were mounting—especially in Europe—that the rapidity of this appreciation could cause inflationary pressures to be exported abroad rather than eliminated.

The central question in these circumstances was how best to ensure stability and continued growth of international trade and finance, along with a reasonable (noninflationary) growth of output. Views on these matters ranged widely, and within the G-7 the United States and France held diametrically opposed positions. The French view essentially was that exchange rate movements were a threat to growth and to economic stability and should be combated through coordinated official intervention in exchange markets. U.S. officials argued that intervention was ineffective and that stability could be achieved only if monetary policies were similar across countries.

This Franco-American debate was hardly new. A similar difference in view surfaced a decade earlier in the wake of the collapse of the par value exchange rate system, as the Committee of Twenty (the forerunner of the Fund's Interim Committee) attempted to forge a new structure to replace it. At that time, a compro-

[11]"Interest rates . . . are likely to remain high where fears of inflation remain strong. But we are fully aware that levels and movements of interest rates in one country can make stabilization policies more difficult in other countries by influencing their exchange rates and their economies." Declaration of the Ottawa Summit (July 21, 1981), para. 6; in Hajnal (1989), p. 105.

mise was reached through intense bilateral negotiations, the essence of which was that IMF surveillance would aim to ensure that member countries were fostering stable underlying economic and financial conditions and a "stable *system* of exchange rates" (emphasis added).[12] Although exchange rates would no longer be fixed, the intention and the hope on the French side had been that policy coordination would bring about stable rates and that surveillance would be sufficiently firm to prevent policies from diverging too greatly. By 1982, with the mix of U.S. policies shifting toward greater monetary restriction and fiscal expansion than other countries felt to be justified, that hope could no longer be sustained.

Versailles, 1982

The renewal of the debate came to a head at an April 1982 meeting of the deputies (or "sous-sherpas") who were preparing for the G-7 summit conference that was to be held at Versailles in June.[13] Michel Camdessus, the French deputy, wanted an agreement to stabilize exchange rates—especially among the three largest countries, the United States, Japan, and Germany[14]—through intervention. Beryl Sprinkel, the U.S. deputy, was adamantly opposed to that proposal and insisted that exchange rate stability could be achieved only through coordination of monetary policies. Although the other delegates at the meeting in Rambouillet, France (the historic site of the 1975 summit), tilted toward Camdessus in what became a "heated debate," Sprinkel effectively blocked agreement on intervention.[15]

On one level, the intervention debate was an exercise in semantics. The U.S. distrust of intervention was based in part on the logic that with monetary policy aiming to control the growth of the stock of money, intervention would have to be sterilized to keep monetary growth on target. This argument gave an apparent precision to the U.S. position that others may not have felt to be consistent with market practice. Everyone would have agreed that unsterilized intervention would have had greater and more lasting effects on exchange rates, but it was not so easy to agree on how practical this notion was. On a deeper economic level, the debate reflected different views about the efficiency of financial markets and about the importance of risk aversion by market participants. In the United States, most officials in the Reagan administration viewed markets as sufficiently efficient and

[12]The quotation is from the amended Article IV. See de Vries (1985), pp. 743–45, on the negotiations to draft the amendment. The main negotiations took place in the fall of 1975 between the U.S. representative, Edwin H. Yeo III, and the French representative, Jacques de Larosière. Also see Pauly (1992) for a discussion of the compromise.

[13]Except as noted, the discussion of this and other meetings of deputies and ministers is based on background interviews with participants.

[14]The French franc and (with wider margins) the Italian lira were already being stabilized against the deutsche mark through the exchange rate mechanism of the European Monetary System.

[15]The "heated debate" characterization has been used both by Putnam and Bayne (1987), p. 133, and by Volcker and Gyohten (1992), p. 353. For more on the U.S. stance against intervention, see the section in Chapter 3 on exchange rate policy in the United States, pp. 149–53.

risk-neutral that sterilized intervention would have only small and very temporary effects on exchange rates, while officials in most other countries at the time saw more scope to influence rates.[16] On a still deeper political level, the debate reflected disagreements about the importance of exchange rate stability (vital to Europe, secondary to the United States), the best strategy for coordinating economic policies (whether to force coordination as the required means to achieve exchange rate stability or to coordinate first and let exchange rates adjust accordingly), and even about the desirability of policy coordination.

The April 1982 deputies' meeting revealed strong differences on each of these levels that the G-7 clearly could not bridge in time for the Versailles summit. To keep from losing momentum and to provide some grist for the summit, Camdessus and Sprinkel agreed to meet separately and work out an acceptable compromise. That led to two proposals, both of which the other deputies reluctantly accepted. First, the summit would commission a study on experience with exchange market intervention, in the hope that it could provide guidance on resolving the Franco-American dispute. Second, in a move with the potential for much greater long-run significance, the deputies agreed to recommend that a multilateral surveillance exercise be developed within the G-7 and that it be conducted in cooperation with the IMF.

A broader issue also arose during these preparatory meetings for the Versailles summit. Whatever strategy evolved for strengthening the international monetary system, the G-7 was keen to play a major role in guiding it. In the 1960s, the G-10 had taken the lead role in developing a consensus among the industrial countries on major systemic issues. In the 1970s, this role had begun to be supplanted by both wider groups (notably the Committee of Twenty and its successor, the Interim Committee) and narrower ones such as the G-5 and the G-7.[17]

With finance ministers meeting often in these varying configurations, tension and confusion were bound to arise over the forum in which key issues of international finance were to be discussed. The largest countries argued that exchange rates and policy coordination were too sensitive to be discussed in a wide forum,

[16]Sterilized intervention in support of, say, the U.S. dollar against the deutsche mark is equivalent to an open market purchase by the Federal Reserve of a U.S. treasury bill and a simultaneous sale of a German mark-denominated treasury bill, to alter the currency composition but not the aggregate stock of securities held by the Federal Reserve. In a perfect risk-neutral market, such an exchange would be expected to leave interest rates unchanged in both countries and thus to have no effect on the exchange rate. If investors require a risk premium to hold securities denominated in a foreign currency, then the exchange rate would be expected to adjust in response to the shift in the currency composition of the outstanding stock of securities. See Boughton (1983) for a technical background on the accounting framework, and Edison (1993) and Dominguez and Frankel (1993) for reviews of empirical evidence (which largely rejects the risk-neutral, efficient-markets hypothesis but finds only weak support for the effectiveness of intervention as it has been practiced). Official views in the early 1980s are summarized (though not explicitly identified by country) in Jurgensen (1983).

[17]In addition to the summit meetings, G-7 officials met regularly as the informal "Bureau" of the Economic Policy Committee (EPC) at the OECD in Paris. At private dinners the evening before the semiannual meetings of the full EPC (in which all OECD member countries participated), the Bureau would review the agenda and prepare a preliminary assessment or summing up of the key policy issues.

but Italy and Canada were reluctant to be left out of the process. After some debate during the preparatory meetings for the Versailles summit, the benefits of the smaller group won out, but three limitations became clear. First, neither the G-5 nor the G-7 had a standing secretariat that could provide background information for multilateral discussions. The deputies and their separate staffs could continue to play that role, but only inefficiently. Second, some means had to be sought for reconciling major differences of view within the group. A decade earlier, the Franco-American debate over how to manage exchange rates was resolved through a bilateral compromise, but positions in 1982 appeared too polarized for that approach. Third, limiting the participants to the G-5 should not imply limiting the perspective of the discussion. Any major policy shifts by the G-5 would affect the rest of the world, and a broad view would therefore have to be taken.

Including the Managing Director of the IMF in the G-5 surveillance exercise would help alleviate each of these problems. The Managing Director could call upon the Fund staff for global information and analysis, he could interject a neutral and independent voice into the discussions, and he could represent the views of the rest of the world.[18] Because the Managing Director would not be precommitted to a particular view on the role of exchange market intervention, this form of surveillance might help bridge the gulf between the French and U.S. positions.[19] After the deputies accepted the Camdessus-Sprinkel proposal to invite the Managing Director to participate in G-5 discussions, the idea was endorsed by the G-5 finance ministers at a dinner meeting at the U.S. Embassy in Helsinki, Finland, just before the May meeting of the Interim Committee.

The formal endorsement of the IMF's role in the process came at the summit conference at Versailles, held on June 4–6, 1982. Attached to the summit communiqué was a "Statement on International Monetary Undertakings," the relevant passages of which were as follows:

1. We accept a joint responsibility to work for greater stability of the world monetary system. We recognize that this rests primarily on convergence of policies. . . .
2. We attach major importance to the role of the IMF as a monetary authority and we will give it our full support in its efforts to foster stability.
3. We are ready to strengthen our cooperation with the IMF in its work of surveillance; and to develop this on a multilateral basis taking into account particularly the currencies constituting the SDR.[20]
4. We rule out the use of our exchange rates to gain unfair competitive advantages.

[18]The G-5 reportedly considered the OECD before the IMF was chosen for this purpose. The Secretary General of the OECD also could call on a highly professional staff to produce an impartial analysis, and the OECD had specific expertise on policy issues affecting industrial countries. The global representation of the Fund was a factor in its favor.

[19]Though the Managing Director—Jacques de Larosière—was French, of course, it may be recalled (footnote 12, p. 191) that he had coresponsibility for the Compromise of 1975. He also had spent several years as the French deputy at G-5 meetings and was well known and respected by the group.

[20]The reference to the "currencies constituting the SDR" is a code for the Group of Five.

5. We are ready, if necessary, to use intervention in exchange rates to counter disorderly conditions, as provided for under Article IV of the IMF Articles of Agreement.

This statement was viewed by both U.S. and European officials as a partial victory. The wording was fully consistent with the U.S. position that stability depended on policy convergence and that intervention could play only a minimal role; but it was also fully consistent with the French view that exchange rate stability was important, that a mutual commitment to that goal was essential if it was to be achieved, and that countries should intervene in conditions of instability.[21] That it was possible to draft a series of apparently firm declarations that equally supported two diametrically opposed visions is a remarkable tribute to the obfuscating political skills of the sherpas and their deputies.[22] The Versailles summit did not resolve any major disagreements, but it did at least set in motion a process that seemed to have the potential for doing so.

De Larosière was, of course, quite ready to accept the invitation from the G-7 to participate in the G-5 ministerial meetings,[23] and he met with the G-5 deputies in early July to begin preparations. That invitation was extended and accepted on the explicit understanding that the Managing Director would be acting "in his personal capacity." His views would be informed both by the staff and the Executive Board, but he would not necessarily be expressing the official views of the Fund. This formulation served two purposes. First, it avoided a debate on the appropriateness of the Fund providing such services to a subset of its members without generalizing the offer to the membership as a whole or creating a formal mechanism for conducting regional surveillance. Second, it enabled the Managing Director to maintain both speed and confidentiality in his communications with the G-5. His positions would not be reviewed or approved by the Executive Board, and he would not be obligated to report formally to the Board on confidential meetings. It also had two drawbacks: it reduced, at least at the beginning, the political weight of de Larosière's presence at the meetings, and it precluded active participation by other Fund officials.

[21]French President François Mitterrand stated in a press conference following the issuance of the communiqué that "the mere fact of being able to examine interventions on the foreign exchange market, while there previously had been no question of it, is for me a source of satisfaction . . . it is not going as fast as I would like, but it is going much faster than others would wish it to." See Hajnal (1989), p. 199 (French original) and p. 220 (translation, from which the above was slightly modified).

[22]The U.S. official position on exchange market intervention (though not the practice of it) contained an element of ambiguity, or perhaps confusion. According to Jacques Attali, the French Sherpa at Versailles, when President Reagan was challenged during the summit by German Chancellor Helmut Schmitt to take charge of intervening to curb currency fluctuations and the rise of the dollar, Reagan replied, "We agree to intervene on the exchange market; that's settled." Later that day, however, Secretary Regan told reporters that he intended to do nothing to brake the rise of the dollar. See Attali (1993), p. 242 (French original). In practice, U.S. intervention remained virtually nil through 1984.

[23]The invitation was made by Camdessus on behalf of the G-7 countries, shortly after the Helsinki meetings in May.

Toronto, 1982

The Managing Director's role was low-key from the beginning. As it happened, the first G-5 ministerial following the Versailles summit was on September 3, 1982, in Toronto, where the ministers were gathered for the Annual Meetings. The surveillance issues that had seemed so important in the spring had been pushed onto the back burner, and the heat had shifted to the debt crisis and thereby to the increased urgency of the proposed quota increase. Nonetheless, de Larosière was invited to make a presentation to the G-5 on the world economic outlook and the policy requirements for convergence.[24]

The G-5 meeting began at 6:00 p.m. at the Harbour Castle Hotel, following the standard practice of the ministers getting together the evening before the Interim Committee meeting.[25] The first hour or so was devoted to the Managing Director's presentation and the ministers' reactions to it. On this seminal occasion, de Larosière stressed three themes: the policy requirements for convergence toward sustainable growth with low inflation (France being especially out of line); the problems stemming from an inadequate containment of government deficits (the United States being especially out of line); and the need to increase the flexibility of each economy (the European countries being especially out of line).[26] Although the meeting was explicitly designed as a surveillance exercise, the Managing Director deliberately avoided the question of whether exchange rates were misaligned. In doing so, he emphasized that, for the major countries, exchange rate alignment was a byproduct of macroeconomic policies and conditions, and that—at least at this time—what mattered most was getting the right medium-term orientation for those policies.

Much of the ensuing discussion centered on the question that de Larosière had not posed: whether the dollar was becoming overvalued and was likely to reinforce protectionist sentiment. De Larosière agreed with that widely held view—indeed, Regan and Sprinkel were the only ones in the room to express satisfaction with the dollar's rise—and noted the danger posed by the possibility that a too-strong dollar could worsen the U.S. external balance and bring a loss of market confidence. Establishing what would become the standard pattern for such meetings, the Managing Director then left. That is, he was invited only for the first agenda item, surveillance, and not for the ensuing discussion of specific policy options. Thus, while he was able to play a significant role in informing the ministers about the world economic outlook and the Fund's views on policy issues, he was not able to turn

[24]The G-5 finance ministers at the time of this meeting were Donald T. Regan (U.S. Treasury Secretary), Geoffrey Howe (U.K. Chancellor of the Exchequer), Michio Watanabe (Japan), Manfred Lahnstein (Germany), and Jacques Delors (France).

[25]Initially, the deputies had considered recommending that the surveillance meetings with the Managing Director be held on an ad hoc basis and be supplemental to the regular semiannual confidential G-5 ministerials. Following the summit conference, however, they decided that for the time being the discussion could be folded into the regular meetings.

[26]Managing Director's background note, in his file "G-10, Vol. I, February 1987–November 1988," in IMF/RD (Accession 88/285, Box 5, Section 250). The French and U.S. economic problems of the time are discussed in Chapter 3.

the occasion into a substantive surveillance exercise, as might have been possible had he been invited to participate throughout the meeting.

Standard practice in the IMF would have called for the Managing Director to report to the Executive Board on important meetings with outside groups such as the G-5 finance ministers. Because the G-5 wished to keep their meetings confidential, however, a formal report would have been impracticable. As noted above, the practice of having the Managing Director participate in his personal capacity had provided a way around this obligation. On the other hand, the Managing Director had no desire to bypass the Board, and he wanted to keep Executive Directors informed as best he could. With that objective in mind, he set up a pair of informal luncheons with groups of Directors in early October, during which he took the opportunity to brief them on his September 3 meeting and to indicate that further such engagements were likely. In this manner, although the Board was not called upon formally to approve the Managing Director's role, Directors were given an informal opportunity to react at an early stage.

The next G-5 ministerial meeting after the Toronto meetings was not seen as calling for a presentation by the Managing Director, although Fund-related topics were high on the agenda. The ministers met at a former royal palace in Kronberg, Germany, in December 1982, where they discussed the Brazilian debt crisis, the proposed quota increase, and a surprising and uncharacteristic proposal by U.S. Treasury Secretary Regan for an international conference on ways to reduce the instability in exchange rates.[27] On each topic, the objective was to develop a common position that could then be presented at wider gatherings. The discussions were therefore private and internal. Whatever input the ministers might have wished from the Managing Director on these issues would have to be sought in other forums or at a later date.

The first opportunity to continue the surveillance exercise came at the end of April 1983. This time the ministers were gathered in Washington on the evening before the Development Committee meeting. The format and the major issues were essentially unchanged from Toronto, with the Managing Director reporting on the world economic outlook and drawing attention to desired policy adjustments. Since the previous September, the main changes in the outlook were that the economic recovery in the United States had accelerated more rapidly than had been foreseen and that French fiscal policy had—just the month before—shifted sharply toward restraint. In these circumstances, the Managing Director emphasized three points: that continued monetary control was essential if inflation was to be held in check, that fiscal deficits had to be further reduced if investment was to recover, and that exchange rates needed to shift so as to "better reflect underlying economic conditions" if world trade and activity were to grow adequately. In particular, monetary growth in France should be further reduced, the United States needed to reduce its fiscal deficit, and—for exchange rate stability as well as for its

[27]Regan's proposal was floated to journalists a few days before the meeting. The goal that he reportedly wanted the proposed conference to achieve was "viscosity" of exchange rates. See the *New York Times*, December 7, 1982, p. A1.

own sake—the five countries together needed to converge toward policies that aimed similarly at achieving “sustained and noninflationary growth.”

Williamsburg, 1983

As the next summit conference approached, very little progress had been made toward resolving the underlying differences in opinion regarding the costs of exchange rate fluctuations or the relative efficacy of exchange market intervention or policy coordination for reducing fluctuations. On April 29, 1983, the same day as the G-5 meeting described just above, the G-7 finance ministers held a preparatory meeting for the summit.[28] There they received the report on intervention that had been commissioned at Versailles and, after much debate among themselves that one participant later characterized as “group therapy” (Howe, 1994, p. 294), released the report to the public along with a covering statement. The report, which became known as the Jurgensen Report (after Philippe Jurgensen, the Deputy Director of the French Treasury who served as Chair of the Working Group), drew a carefully balanced conclusion (p. 17):

> . . . intervention had been an effective tool in . . . influencing the behaviour of the exchange rate in the short run. Effectiveness had been greater when intervention was unsterilized than when its monetary effects were offset. . . . sterilized intervention did not generally have a lasting effect, but . . . intervention in conjunction with domestic policy changes did have a more durable impact. At the same time, it was recognized that attempts to pursue exchange rate objectives which were inconsistent with the fundamentals through intervention alone tended to be counterproductive.

Nothing in the report suggested that the value of intervention was less than the mainstream of its advocates had suggested, but it did little to bridge the gulf between those advocates and the U.S. opposition. Consequently, the ministers’ own statement acknowedged that gulf with unusual frankness (“Views have differed among us . . . and our practices . . . have differed widely”) and then announced that they had reached agreement on the following:

A. The achievement of greater exchange rate stability, which does not imply rigidity, is a major objective and commitment of our countries.
B. The path to greater exchange rate stability must lie in the direction of compatible mixes of policies. . . .
C. In the formulation of our domestic economic and financial policies, our countries should have regard to the behavior of exchange rates. . . .
D. Under present circumstances, the role of intervention can only be limited. Intervention can be useful to counter disorderly market conditions and to reduce short-term volatility . . . while retaining our freedom to operate independently, [we] are willing to undertake coordinated intervention in instances where it is agreed that such intervention would be helpful.

[28]This meeting appears to have been the first in which the G-7 finance ministers met as a separate group rather than as the G-5 or as part of the full sherpa group planning the summit; see Garavoglia (1984), p. 34. It was, however, not a shift in structure, but rather an ad hoc event to release the intervention study commissioned by the summit countries.

The first three clauses were little more than a repetition of the Versailles communiqué, while the fourth was an attempt to resolve the debate over intervention. As the final sentence illustrates, however, with its curious reference to "retaining our freedom" (as if that had ever been in doubt), the ministers had in effect agreed to continue to disagree.

Shortly after the G-7 meeting, French President Mitterrand took up the stable-exchange-rate cause during a soirée at the Élysée palace for ministers of finance and foreign affairs attending the annual ministerial Council meeting of the OECD in Paris. After noting that the G-7 had agreed to act together when necessary to counter volatility in exchange rates, he concluded that "the time has come to think of a new Bretton Woods . . . organized . . . at the highest level, in the framework of the International Monetary Fund." Since Secretary Regan had made essentially the same suggestion five months earlier and reportedly expressed support for Mitterrand's proposal,[29] it was beginning to appear that the French and the Americans were moving closer together on the key issue of the need for an international monetary system founded on a new set of rules. Over the next few years, however, the U.S. position would continue to vacillate.

The language of the ministerial communiqué was repeated in abbreviated form in the communiqué issued at the conclusion of the Williamsburg summit, complete with the insistence that each country would retain its freedom in determining intervention policy (Hajnal, 1989, pp. 234–40). The summit conference, held in the historic reconstructed village of Williamsburg, Virginia, at the end of May 1983, reaffirmed the procedural innovations introduced at Versailles a year earlier and promised that the "consultation process" would be "enhanced to promote convergence of economic performance . . . and greater stability of exchange rates." As for a "new Bretton Woods"? The leaders asked the finance ministers, "in consultation with the Managing Director of the IMF, to define the conditions for improving the international monetary system and to consider the part *which might, in due course*, be played in this process by a high-level international monetary conference" (emphasis added). The fire that Secretary Regan had lit in December and whose flames President Mitterrand had stoked in May had not exactly been snuffed out, but the embers were now untended at the back of the hearth.[30]

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[29]Attali (1993), p. 449, quotes from a May 18 letter from Regan to Mitterrand declaring his support. Four days earlier, however, Regan was described by *The Times* of London (May 14, 1983, p. 11) as having "poured cold water over" Mitterrand's call for a "Bretton Woods No. 2."

[30]Similar suggestions emanated from both within and without the G-7. Japanese officials expressed interest at that time in strengthening the system so as to limit exchange rate volatility, though no specific scheme was endorsed as official government policy. In May 1983 (in a speech in Toronto before the Financial Analysts' Federation), Toyoo Gyohten—the Japanese delegate on the Jurgensen committee and later the Finance Deputy at G-5 and G-7 meetings—advanced a proposal for a joint intervention account to be established by three or more of the largest countries and to be managed so as to apply pressure for policy convergence. In September 1983, the G-24 ministers issued a communiqué calling for "the convening of an international monetary conference" as a step in securing "a thorough-going reform of the international monetary and financial system" aimed at, inter alia, stabilizing exchange rates (paragraph 21); *IMF Survey* (October 10, 1983), p. 299.

The Managing Director's third meeting with the G-5 ministers came at Blair House on September 24, 1983, in the margins of the Annual Meetings in Washington. The IMF staff's preparations for these G-5 events had now developed into a regular production effort. An ad hoc interdepartmental working group had been formed to draft a paper on economic developments and policy options, which would be circulated to participants ahead of the meeting and would serve as a background note for the Managing Director's remarks. In addition, the staff would prepare an extensive set of tables and charts on macroeconomic developments in each of the five countries. These tables and charts (vernacularly known as the "Versailles tables") included annual data for the past several years and IMF staff projections for the current and following year on output, prices, and a wide range of financial variables. Overall, the data were intended to be commensurate across countries, except for policy measures such as monetary aggregates and fiscal deficits, where the officials preferred to use national definitions.

The Versailles tables, along with the background paper, were circulated to the deputies three or four weeks ahead of each ministerial meeting to facilitate discussion and concentrate attention on key areas where convergence was lacking. Unfortunately, the right formula had not yet been found for reconciling the conflicting goals of comprehensiveness and conciseness. More than forty data series were included, forming an intimidating thicket of numbers from which the crucial kernel could scarcely be extracted. The circulated material thus was too diffuse to succeed fully in stimulating or focusing discussion of the Managing Director's remarks to the ministers. As before, at the September 1983 meeting the Managing Director presented his assessment of the economic situation facing these countries and emphasized that fiscal policies should be aimed at the crucial objective of lowering interest rates to bring about a revival of private sector activity. He then answered a number of questions, but as usual he was not invited to stay through the more substantive policy debates.[31]

Meanwhile, the summit directive to finance ministers to "define the conditions for improving the international monetary system" was taken up by the G-10 ministers and governors at their September 1983 meeting, at the request of their Chairman, Jacques Delors (France). Although the G-7 had undertaken the study of intervention policy the year before, the ministers did not wish to set up a more permanent bureaucracy in competition with the others to which they already belonged, and the G-10 was the natural choice for the task at hand. Following a discussion in which the Managing Director took part, the G-10 instructed their deputies, chaired by Lamberto Dini of the Bank of Italy,[32] to "identify the areas in which progressive improvements may be sought" and to report back to the minis-

[31]For an account of this meeting, see Lawson (1992), p. 515.

[32]Central bank governors play a more substantive role in the G-10 than in the G-5 or the G-7. At ministerial meetings in the two smaller groups, participation is generally limited to the finance minister, the minister's deputy, and the governor; preparation for the meetings is the responsibility of the ministers' deputies. In the G-10, the preparatory role is shared between the governors' and ministers' deputies. See also footnotes 5 and 6, p. 187.

ters and governors in the spring of 1984.[33] This instruction would lead to a thorough study by the deputies, including recommendations on how to strengthen the functioning of the system and the role that IMF surveillance might play in that regard. What remained to be seen was whether those recommendations would include substantive changes or be limited to window dressing.

London, 1984

Little was said about surveillance at the London summit in June 1984, and little progress was made that year toward strengthening the multilateral process. The G-10 deputies submitted a progress report to their ministers and governors in May 1984, but no agreement was in sight on the most contentious issues on the roles of intervention and other means of stabilizing exchange rates. The French deputies (Camdessus and Gabriel J.A. LeFort, deputy governor of the Banque de France) were pushing to include a favorable finding on some concrete means of inducing exchange rates toward consistency with economic conditions, preferably in the form of "target zones": commitments to try to keep exchange rates within specified ranges, through intervention and policy convergence (Williamson, 1985; Williamson and Miller, 1987). Some of the smaller countries in the group seemed open to the idea, but the other G-5 countries were opposed. The London summit communiqué (see Hajnal, 1989, pp. 258–65) took no position and merely asked that the project be continued.

The Managing Director met once with the G-5 ministers, at Blair House in Washington in April 1984, but he was not invited to the September meeting. By that time, the appreciation of the U.S. dollar had reached alarming levels with no end in sight, and the Reagan administration was coming under increasing pressure to relax its stance against intervention. Secretary Regan, as the host of the meeting, decided not to include the standard surveillance session with the Managing Director, and during the meeting he again rejected his peers' requests for coordinated intervention (Lawson, 1992, p. 530).

The Executive Board held its annual review of the implementation of surveillance for 1984 in March, and the role of surveillance with the G-7 countries was a key issue for discussion. The background staff paper noted the Managing Director's participation in the G-5 meetings and reported on the Managing Director's efforts to focus attention on domestic policy adjustments for convergence and stability over the medium term.[34] Directors agreed that policy convergence was important for stability and that to monitor convergence required examining the

[33]Communiqué of the ministerial meeting of the Group of Ten, Washington, September 24, 1983; in *IMF Survey*, Vol. 12, No. 19 (October 10, 1983), p. 294. The decision to assign the task to the G-10 deputies was taken earlier, through bilateral contacts between Delors and his peers. It was taken up informally by the deputies at a meeting on September 15 and then formalized by ministers on September 24.

[34]"Review of the Document 'Surveillance Over Exchange Rate Policies' and Annual Review of the Implementation of Surveillance," SM/84/44 (February 15), p. 17.

whole spectrum of macroeconomic policies in each country. Nigel Wicks (United Kingdom) noted that when fiscal and monetary policies were “tugging in opposite directions,” assessing the level of the exchange rate was especially difficult. Wicks concluded that with the application of a range of surveillance tools, including “the Managing Director’s various informal contacts,” the Fund could play a role in “steering domestic policy developments in a desirable direction.” The benefits of the Managing Director’s role in the G-5 meetings were also acknowledged by Ghassem Salekhou (Iran). Other Directors, however, were more skeptical. E.I.M. Mtei (Tanzania) argued that “the Fund had not yet devised an effective mechanism for making surveillance over the exchange rates and other policies of the large industrial and other surplus countries effective.” The national interests of the G-7 countries frequently diverged, and he found it unlikely that policy coordination could be achieved without clearly defined rules.

The U.S. Executive Director, Richard D. Erb, also raised fundamental concerns about the application of multilateral surveillance, in an intervention that clearly suggested the skepticism toward international coordination that pervaded the U.S. Treasury under Secretary Regan.[35] Erb called into question two frequently made arguments for using surveillance to promote policy convergence. First, he argued that what was needed was convergence of economic conditions toward sustainable growth with stable prices; the policy requirements for achieving that goal might differ substantially from one country to another. In contrast to the view often expressed by the staff and by other Directors, he saw little evidence that exchange rate instability could be explained by countries adopting different mixes of monetary and fiscal policy.[36] This argument implied that the shift in the mix of U.S. policies in the early 1980s toward slower monetary growth and larger fiscal deficits need not be considered inconsistent with the radically different strategies being pursued by Germany and Japan. Second, the difficulty the major countries had experienced in achieving convergent economic conditions did not, in the U.S. view, result from a failure to take full account of the implications of their policies for other countries. If countries were independently to pursue policies that were in their own long-term interests, the international ramifications would generally be positive. In this view, the problem was rather that countries found it difficult to implement the policies that were in their own long-term interests.

With the largest member country reluctant to engage in exchange market intervention and skeptical of the value of policy coordination, there was little that the other G-5 countries or the IMF could do to strengthen the multilateral surveillance process. In the event, however, 1984 would be the dark hour before the dawn of a more cooperative spirit.

[35]Minutes of EBM/84/40 (March 12, 1984), pp. 5–6 and 14.

[36]The staff view, as expressed in the background paper, was as follows: “Experience in recent years suggests that, at least for the major industrial countries, recourse to a domestic policy stance that fails to take account of the implications for other countries has often been a more serious problem than the implementation of policies designed to manipulate exchange rates or the international monetary system.” See “Review of the Document ‘Surveillance Over Exchange Rate Policies’ and Annual Review of the Implementation of Surveillance,” SM/84/44 (February 15), p. 15.

Cooperation and Coordination: 1985–87

Bonn, 1985

The atmosphere for multilateral surveillance improved dramatically in the early months of 1985, largely out of necessity, as the view took hold that exchange rates had to be stabilized. Currency speculation—unrelated to the requirements of international trade and even going well beyond what could reasonably be attributed to the financial effects of differences in the mix of macroeconomic policies—was now almost totally controlling movements in exchange rates and was preventing the normal conduct of international economic policy. In the parlance of the times, exchange rate movements were judged to be "unrelated to the fundamentals," disrupting trade and inflaming pressures for protectionist policies. For the five months through late February 1985, the deutsche mark depreciated against the U.S. dollar by nearly 15 percent, to a record level of 3.47 marks per dollar; the Japanese yen, by more than 7 percent, to 263 yen per dollar; and the pound sterling, by close to 20 percent, to an all-time low of $1.04 per pound.[37] This bubble would surely burst, but when and with what force was the question that was echoing around the globe.

Threatened with a potentially calamitous currency panic, the German finance minister, Gerhard Stoltenberg, asked for a January meeting of the G-5 ministers to try to get the group to shift to a more actively cooperative approach. Now that the presidential elections were over in the United States, the chances for action to reduce the U.S. fiscal deficit were improved. That possibility might induce markets to reinforce an official nudge to reduce the cost of the dollar. Regan agreed to call a meeting, which was fixed for January 17 at the U.S. Treasury in Washington.[38] For the first time since the previous April, the Managing Director was invited for part of the all-day meeting, to make a 30-minute presentation on the outlook and on the key surveillance issues and to answer questions. He again stressed the need for a correction in U.S. fiscal policy as the basic underlying requirement for lasting stability in exchange rates and economic conditions. Whatever thoughts the ministers might have had in reaction to this injunction, their immediate purpose lay more in examining the art of the possible-in-the-short-run: what could they do now to foster a realignment of exchange rates? For the moment, what was needed was not so much surveillance as a common will to act.

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[37]The extent to which exchange rates respond to purely speculative forces rather than to information on—and rational expectations of—economic policies and conditions was, and still is, controversial, because the effect of such "fundamentals" is difficult to measure. By any standard, however, the currency movements experienced in the last quarter of 1984 and the first month or two of 1985 were extreme outliers. The Fund staff conducted econometric tests of the behavior of the real effective exchange rate of the dollar as a background study for the 1985 Article IV consultations with the United States. That study concluded that "a substantial portion of the real appreciation of the dollar, particularly in the second half of 1984, remains unexplained." See "United States—Recent Economic Developments," SM/85/209, Sup. 1 (July 22, 1985), Appendix IX.

[38]This meeting is described in Lawson (1992), pp. 473–75, and in Volcker and Gyohten (1992), p. 240. Additional information is from interviews with participants.

For four years, the will to act together had been blocked by a U.S. policy stance founded on independence and opposition to intervention. In January 1985, the European members of the G-5 presented a united front for coordinated action. The three delegations—led by Stoltenberg for Germany, Pierre Bérégovoy for France, and Nigel Lawson for the United Kingdom—breakfasted together on January 17 before going to the meeting with the United States and Japan (Lawson, 1992, p. 473). At the treasury, the U.S. team was still headed by Regan, but this would be his last G-5 meeting. That evening, Paul A. Volcker, Chairman of the Federal Reserve System, held a dinner for the participants at the Federal Reserve headquarters. James A. Baker III, President Reagan's chief of staff, attended as a special guest; Baker and Regan had just won the president's approval to swap jobs, so Regan was introducing his successor to his G-5 colleagues. At the very moment when the Europeans were most eager to persuade the United States to change its stance on international economic cooperation, the U.S. baton was being passed to a man who would soon gain a reputation as a mastermind of policy coordination.[39]

The January meeting produced a commitment "to work toward greater exchange market stability." The text of the communiqué did not go beyond the vague commitments made earlier in the G-7 summit communiqués, but the mere fact that the G-5 finance ministers were willing for the first time to issue a public joint statement on the subject was seen as a major step forward. The signal was thus given that the period of benign neglect was over. The immediate goal of the G-5 in mid-January was to stop the free fall of the pound sterling, not necessarily to reverse the course of the dollar. Nonetheless, the meeting set the stage for what would soon be large-scale coordinated exchange market intervention to halt the dollar's appreciation. The European central banks took the lead in that effort, starting shortly after the January 17 meeting, and the U.S. Federal Reserve jumped in within a few days. In less than two months and after some $10 billion in official intervention by the central banks of the G-7,[40] the direction of the dollar was finally reversed around the end of February.

By April 1985, with the dollar firmly in retreat from its unsustainable heights, attention could be turned again to the longer-run question of how best to prevent such extreme swings in exchange rates. The G-10 deputies were in the final stages of drafting their report on the functioning of the international monetary system, and attention had to turn to the question of how to assess and carry out the recommendations that might be forthcoming. One possibility was to resuscitate the Regan-Mitterrand strange-bedfellow proposal for a "new Bretton Woods" conference. First in the ministerial Council of the OECD and then in the Interim Com-

[39]Destler and Henning (1989), Chapter 3, explain Baker's willingness to work toward greater cooperation as motivated largely by domestic political pressures, driven by the adverse effects of the strong dollar on the U.S. business sector. De Larosière (1992) discusses the strengthening of the coordination process after Baker replaced Regan.

[40]Volcker, in Volcker and Gyohten (1992), p. 240, indicates that the Federal Reserve accounted for $660 million of a $10 billion total by early March, the biggest participant having been the Deutsche Bundesbank ($4.8 billion). For an account of day-to-day intervention, see Dominguez and Frankel (1993), pp. 11–13, 88–90, and 150–51.

mittee, Secretary Baker floated that idea. As he put it at the Interim Committee meeting on April 18, the United States was

> prepared to consider the possible value of hosting a high-level meeting of the major industrial countries, following the conclusion of the [G-10] studies, in order to review the various issues involved in transforming their findings into appropriate action. Such a meeting could provide further impetus to strengthening the international monetary system through the IMF, in particular through the upcoming review of the G-10 studies by the IMF's Interim Committee.[41]

Baker's call for a high-level conference was again supported by the G-24 ministers[42] but nonetheless drew little support within the Interim Committee. The proposal was not included in the communiqué, and both Nigel Lawson (United Kingdom) and Onno Ruding (Netherlands) tried to dissuade Baker from pursuing the idea.[43] The Bonn summit conference was held a few weeks afterward (May 2–4, 1985). That communiqué took note of the continuing work of the G-10 on ways to improve the functioning of the international monetary system, but it did not mention any follow-up strategy other than for the Interim Committee to discuss the forthcoming report. By June, when the G-10 ministers were to meet in Tokyo, Baker had apparently abandoned the plan for a general conference in favor of organizing a coordinated (though ad hoc) strategy to manage exchange rates within the G-5. Despite that shift, the G-24 ministers again called for a conference, proposing in October that reforms be considered by "a representative committee of Ministers from developing and industrial countries, which could perhaps take the form of a joint subcommittee of both the Interim and Development Committees."[44]

Inside the IMF in the first months of 1985, attention was directed at changes to the practice of surveillance with the large industrial countries that might help to promote stability within the existing system. A February 1985 staff paper prepared for the annual review of the implementation of surveillance floated the idea that a system of "objective indicators" might help to strengthen multilateral surveillance by focusing attention on the data that mattered most.[45] Although the list of

[41]Statements made at the Interim Committee Meetings, Washington, D.C., April 17–19, 1985; Master File in IMF/CF.

[42]G-24 communiqué (April 16, 1985), paragraph 69; in *IMF Survey* (April 29, 1985), p. 137. See also footnote 30, p. 198.

[43]Baker's proposal at the OECD ministerial, and the reactions of Lawson and Ruding, were reported to the Managing Director by the Fund's observer at the meeting. Cable to the Managing Director from Aldo Guetta (April 12, 1985); in IMF/RD Managing Director file "G-10 January–May 1985" (Accession 87/136, Box 4, Section 168). Lawson's reaction is also described in Lawson (1992), p. 533. At the Interim Committee meeting, Baker told Camdessus privately that he favored the idea of trying to keep exchange rates within reasonable bounds as long as countries were not publicly committed to defending specific ranges.

[44]G-24 Communiqué (October 5, 1985); in *IMF Survey* (October 28, 1985), p. 313.

[45]"Enhancing the Effectiveness of Surveillance: The 1985 Annual Review of the Implementation of Surveillance," SM/85/65 (February 22, 1985), pp. 29–30. The case for indicators as part of a process for coordinating macroeconomic policies may also be found in Crockett (1988). The concept of objective indicators as the basis for IMF surveillance originated in a November 1972 paper by Paul Volcker and J. Dewey Daane, prepared in their capacity as U.S. deputies to the

specific indicators was yet to be specified, the idea was similar to the way performance criteria are used in Fund-supported adjustment programs, albeit without the *requirement* of a policy response. If, for example, a country would indicate that it wanted to see its money stock growing at a rate within a specified range, then movements outside that range could trigger discussions of the policy adjustments that would be needed to restore balance.

When the Executive Board conducted its surveillance review in late March 1985, Directors generally reacted favorably in principle but skeptically in practice to the systematic use of objective indicators. The U.S. and French positions were the bookends, as they often were when exchange rate stability was on the agenda. The French Director, Bruno de Maulde, strongly supported the proposal but expressed concern that not enough emphasis was given by the staff to what in his view was the central role of the exchange rate itself as an indicator. At the other extreme, the U.S. Director, Charles H. Dallara, criticized the proposal as not being "particularly feasible or realistic," since countries without need of Fund resources might also feel no need for Fund policy advice. In between, most Directors who addressed the issue regarded objective indicators as worth trying but as unlikely to produce any significant changes in the practice of Fund surveillance. Without a clear mandate, the Managing Director concluded "that, for the time being at least, the use of such indicators in particular cases where they might be appropriate and acceptable would be limited to providing a basis for reviewing, in the course of an Article IV consultation, developments against the background of the conclusion of the previous one."[46]

Meanwhile, the G-10 report on the functioning of the international monetary system and a parallel report by the G-24 deputies[47] were being circulated and discussed. The G-10 deputies met in Paris in April, in Basel in May, and in Tokyo in June to finalize their report. Although the French team kept battling to include support for target zones for exchange rates, they were continually defeated by an op-

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Committee of Twenty and submitted to the Committee as an official U.S. proposal. For the background and context, see de Vries (1985), pp. 165–69. The paper, reprinted in U.S. Council of Economic Advisers (1973), summarized the proposal as follows (p. 163):

> Without objective indicators there is a danger that needed actions [to reduce external imbalances] will not be taken. It is much better to get advance agreement in principle that when certain internationally agreed indicators, recognized as being objective, signal adjustment is needed, there will be a strong presumption that appropriate measures will be adopted—but recognizing there might be valid reasons for overriding the indicators in exceptional cases.

[46]Minutes of EBM/85/48 (March 22, 1985), pp. 16 (Dallara) and 31 (de Maulde); and EBM/85/49 (March 25), p. 10 (summing up).

[47]The G-10 and G-24 reports are reproduced, as Appendix I and II, respectively, in Crockett and Goldstein (1987). The G-24 report was commissioned by the Chairman of the G-24 ministers, Juan V. Sourrouille of Argentina, on May 28, 1985. He appointed Arjun Sengupta—Executive Director (India) in the Fund—to chair a working group to prepare a draft report by end-July, and in the interests of time he authorized the deputies to act on behalf of the ministers and transmit the report directly to the Interim Committee. The staff of the Fund provided informal assistance to the G-24 for the preparation of this report. (The background to the G-10 report is discussed above, on pp. 199–200.)

position led by U.S. deputy David C. Mulford. The U.S. authorities opposed target zones because they believed that private financial markets should be left alone to determine the exchange rate. They were joined by German officials (especially from the Bundesbank) who were opposed to any proposal that would require intervention to supersede domestic monetary control as a guide for central bank policy.

The G-10 finance ministers and central bank governors, with the Managing Director participating, met in Tokyo on June 21 to discuss the report and release it for publication. Two months later (August 19–21), the G-24 deputies met at IMF headquarters in Washington, completed work on their report, and issued the approved text to the Interim Committee on behalf of their ministers. That report noted the importance of exchange rate stability for developing countries and took a more favorable stance toward the adoption of target zones. The Interim Committee agreed to hold a preliminary discussion of both reports at its October 1985 meeting in Seoul, Korea, after which it would ask the Executive Board to prepare a report so that ministers could try to come to some conclusions at the next meeting.

As the summer of 1985 drew to a close, a variety of efforts thus were under way to reform the international monetary system. At the same time, more ad hoc efforts were being made to deal with the immediate problem of exchange rate misalignment through coordination of policies. Ultimately the success of the short-term effort would draw attention away from the more structural proposals and would even be seen as obviating the need for systemic reforms.

Plaza, 1985

The coordination effort began in great secrecy in June 1985, which for a time precluded any role for the IMF. This part of the story is recounted here because it helped resolve the systemic issues that had been debated since Versailles and because it laid the foundations for a later strengthening of the Fund's role in multilateral surveillance.

Baker's G-5 deputy, Mulford,[48] initiated the process by meeting with his Japanese counterpart, Tomomitsu Oba, the day before the ministerial meetings opened in Tokyo. Mulford informed Oba that Baker intended to propose a G-5 program to induce a further depreciation of the U.S. dollar. Oba was immediately receptive to the idea—as was the finance minister, Noboru Takeshita, when Baker raised it with him a day or two later—recognizing that the prevailing exchange rates were making it ever more difficult to control their large and growing current account surplus. Nonetheless, the seed would have to grow in the dark for a while before being transplanted more openly. It was not on the agenda at the private G-5 meeting on June 20, nor at the announced G-10 meeting on the 21st, nor for Baker's bilateral talks with the other G-5 ministers. Furthermore, although de Larosière

[48]The deputy responsibilities under Secretary Baker were shared between Mulford (Assistant Secretary of the Treasury for International Affairs) and Richard G. Darman (Deputy Secretary). Mulford was the delegate to meetings of the G-5 deputies. See Funabashi (1988), pp. 145–47, for a discussion of the political ramifications.

was in Tokyo from the 19th for the G-10 meeting, he was not invited to participate in the G-5 meeting and was not informed of the Baker initiative.[49]

In August, following further discussions with Japanese officials, Baker telephoned each of the other G-5 ministers to seek their support for holding a special meeting to coordinate a realignment of exchange rates. He asked them not to inform their central bank governors until the planning was well under way and suggested that their deputies meet to develop a detailed plan. Because of the extreme sensitivity of the endeavor, however, the deputies did not initially meet in their usual joint format. Over the next few weeks, Mulford and Richard Darman met bilaterally with Oba, Hans Tietmeyer (Stoltenberg's deputy), Geoffrey Littler (Lawson's deputy), and Daniel Lebègue (Bérégovoy's deputy). In early September, Mulford and Tietmeyer flew to Heathrow Airport outside London, where they met secretly with Littler to draw up the outlines of a draft communiqué. Finally, on September 15, all five deputies spent a full day in London drafting a communiqué and a discussion paper for the ministerial meeting.[50]

By September 1985, the effective exchange rate for the U.S. dollar had depreciated by 8½ percent from its February peak, but it was still generally acknowledged to be well above the range considered to be compatible with desirable or sustainable current account balances. Moreover, the decline had stopped in late August and had shown an alarming reversal during the first half of September. The finance deputies, having all lived through the seemingly irresistible rise of the dollar just a few months before, needed little convincing that a concerted effort might be required to nudge exchange rates in the right direction. They therefore concluded that a 10–12 percent further depreciation of the dollar against each of the other G-5 currencies was to be encouraged through coordinated official exchange-market intervention and backed up by a commitment by each country to pursue appropriate monetary and fiscal policies.

The ministerial meeting was to be held at the Plaza Hotel in New York on Sunday, September 22, 1985. As the weekend approached, no one except those immediately involved knew that the meeting was being planned. Even most of the central bank governors were kept in the dark, as was the Managing Director.[51] On

[49]The bilateral U.S.-Japan talks are described in Funabashi (1988), p. 11. The importance of the Tokyo meetings in setting the stage for the Plaza meeting in September is discussed by Gyohten in Volcker and Gyohten (1992), p. 251. Additional information is from background interviews with participants.

[50]For published accounts, see Funabashi (1988), p. 13, and Volcker and Gyohten (1992), p. 244 (Volcker's account) and pp. 253–54 (Gyohten's).

[51]Baker informed Volcker in August and asked for (but did not get) an assurance that U.S. monetary policy would not be tightened to counteract the intended depreciation. From that point, Volcker was heavily involved in the planning. Camdessus, then governor of the Banque de France, was peripherally involved. President Reagan was not informed until a day or two before the meeting; see Volcker and Gyohten (1992), pp. 242–43. The president of the Bundesbank, Karl Otto Pöhl, also learned of the meeting just days before, when Tietmeyer telephoned him in San Francisco (where Pöhl was attending a conference). Pöhl was angered by the slight and was persuaded not to rebel only after a breakfast meeting with Volcker and Camdessus on Sunday. Camdessus informed an unhappy de Larosière on Saturday that the meeting was scheduled, and Volcker debriefed him over lunch on Monday. The U.S. and French delegates, respectively, informed their excluded counterparts from Canada and Italy during the weekend.

Saturday, the three European finance ministers from the G-5 were in Luxembourg with their colleagues from other EC countries at their regular informal monthly meeting. Saturday evening, around the same time as the press were being notified in New York that a meeting would be held the next day, they notified the others of what was about to take place. They then flew on the Concorde to New York on Sunday morning, arriving in time for the 11 a.m. meeting.

The Plaza meeting lasted most of the afternoon. At its closure, the ministers and central bank governors issued a lengthy communiqué concluding that "some further orderly appreciation of the main nondollar currencies against the dollar is desirable" and announcing that they stood "ready to cooperate more closely to encourage this when to do so would be helpful." The tortured prose in the first clause was necessary to avoid the psychologically troubling idea of encouraging a dollar depreciation. Volcker, in particular, was concerned about the possibility of a *dis*orderly depreciation that might be difficult to control.[52] The shunning of the word "intervention" in the second clause was more curious, since all five countries were now clearly prepared to intervene in the foreign exchange markets to achieve this objective. Without necessarily downplaying that commitment, the vague wording served to draw attention to the additional commitments to cooperate in getting monetary, fiscal, and structural policies right.

To understand the way the international financial system evolved in the post-Plaza period, one must first understand what the Plaza accord did and did not do. The most concrete agreement to emerge from the meeting was a specific joint commitment to intervene to achieve a realignment of exchange rates. That agreement was not the beginning of the process; the five countries had informally carried out joint intervention several times in the preceding months (Dominguez and Frankel, 1993, pp. 11–13). Nor did it dramatically change the direction or even the magnitude of the trend movements in exchange rates, although it may have prevented the dollar's depreciation from stalling. It did not represent a change in the structure of the G-5 process (the ministers and governors had been meeting for years, and the first communiqué was issued after the Washington meeting in January 1985), nor in the relationship between the G-5 and the IMF in overseeing the system. It did not even generate specific commitments to coordinate monetary policies. What the Plaza accord did was establish a basis for major-country cooperation in which the roles of intervention and underlying domestic policy adjustments were clearly and properly delineated. Although many of the policy commitments of the Plaza eventually died on the vine, the seed was now planted in the sunshine. At least on paper, the Plaza accord finally resolved the decades-old Franco-American intervention-convergence debate by recognizing that policy convergence was necessary but not sufficient for exchange rate stability.

[52]"The possibility at some point that sentiment toward the dollar could change adversely, with sharp repercussions in the exchange rate in a downward direction, poses the greatest potential threat to the progress that we have made against inflation" (Volcker, 1985, p. 695). Volcker had witnessed at close hand the disorderly attack on the dollar's parity in the early 1970s, when he was Under Secretary of the U.S. Treasury for Monetary Affairs.

The Plaza accord also made possible a strengthening and deepening of the role of the IMF in the multilateral surveillance process. Since the Versailles summit three years earlier, the process had amounted to a half-dozen ministerial meetings at which the Managing Director had presented his views on economic conditions and macroeconomic policy options. At no time had de Larosière felt it to be appropriate to suggest "right" levels for exchange rates, although he had supported the view that the strength being shown by the U.S. dollar at the time was harmful and unsustainable. In part this reluctance reflected the inherent ambiguities in assessing the market levels of floating exchange rates; in part it reflected a desire to concentrate more on underlying domestic policies. The deeper problem, then, was that the format did not provide him an opportunity to question the ministers systematically regarding their policy intentions. If the surveillance process was to be effective, there would have to be feedback and follow-up.

The first chance to sharpen the pencil came soon after the Plaza, at the Annual Meetings in Seoul in early October. The G-5 ministers met with the Managing Director on the Saturday afternoon preceding the formal meetings, October 5, at the Hilton Hotel. Reminiscent of the first such gathering in Toronto three years earlier, the ministerial minds were engaged more on debt than on policy cooperation, this time because the Baker Plan (see Chapter 10) was about to be unveiled. Nonetheless, de Larosière took the opportunity provided by the post-Plaza cooperative spirit to go beyond the now-routine litany by posing specific questions. For example, how far was the U.S. Federal Reserve now prepared to go in directing monetary policy at the exchange rate? When and by how much did the German authorities intend to implement tax reductions in 1986? How might Japanese policies respond if the correction in the yen-dollar exchange rate were to be reversed? The object was not to interrogate or to attempt to pry answers loose, but to direct attention to key issues that could be pursued in more detail in the forthcoming Article IV consultations. The result was a more substantive and concrete exchange of views than had been possible before.

Tokyo, 1986

By the beginning of 1986, the primary concern for the major countries was that economic growth was slowing, especially in the United States. As the Managing Director had noted at the October 1985 G-5 ministerial meeting, growth in both Germany and Japan had been sustained by strong external demand. As U.S. growth slowed, prospects for those and other countries would weaken as well. The use of tax cuts or public spending to stimulate growth was effectively ruled out because of the poor state of public finances, so the burden was on monetary policy. Aggregate demand and the demand for petroleum in particular were weak enough that interest rates could be lowered without rekindling inflation, but could the cuts be coordinated so as not to disrupt the exchange rate stability that was finally being achieved?

Engineering a coordinated reduction in interest rates proved to be quite difficult, and that experience led to the next (and apparently final) effort to develop a more formal IMF-related structure for coordinating policies. The first serious move to put interest rate reduction on the G-5 agenda came at a ministerial meeting in London

on January 18–19, 1986.[53] The surface problem in winning agreement on a coordinated reduction was the opposition of central bank governors, especially Volcker (see Volcker and Gyohten, 1992, p. 247). In addition, there was a structural problem in that the G-5 meetings were essentially meetings of finance ministers, not all of whom had authority to effect the changes in monetary policy that would in turn move interest rates. Although the central bank governors participated in the meetings, their deputies did not participate in the preparatory meetings where the agendas were fixed and the background papers and communiqués were drafted. This structure conveyed a measure of political authority and camaraderie to the meetings, but it also limited the scope for action. In France and the United Kingdom, the governors served under the finance minister and the chancellor, respectively. The other three governors, however, were more independent, would not generally have felt bound by ministerial agreements, and in any case might not have been able to convince their own governing boards to carry out an agreed policy.

A few weeks after the London G-5 meeting, Volcker and Karl Otto Pöhl (president of the Deutsche Bundesbank) met privately during the monthly meeting of the BIS governors in Basel, Switzerland, and agreed to propose interest rate reductions to their respective boards.[54] By this time, the pressure to act was becoming severe for both men. Volcker was facing an internal revolt in the Federal Reserve Board over his opposition to a unilateral cut in the U.S. discount rate, and the monthly discussions of U.S. and German policies among governors at the BIS were becoming pointed and heated. The bilateral agreement between Volcker and Pöhl enabled a round of interest rate cuts by all the G-5 central banks, starting on March 6, 1986.[55] That achievement, however, was an ad hoc event that did not represent a breakthrough in the G-5's ability to coordinate policies for the commonweal.

While the G-5 was thus stumbling along the path to recovery in the spring of 1986, its existence as the primary forum for multilateral surveillance was coming to an end. Italy, where resentment at being excluded had remained strong ever since the G-5 had taken the reins at Versailles in 1982, was insisting that the G-7 was the proper grouping for this purpose. The Bank of Italy, despite Italy's exclusion from the Plaza meeting, had participated fully in the ensuing intervention exercise.[56] By early

[53]For accounts of this meeting, see Funabashi (1988), pp. 43–44, and Lawson (1992), pp. 543–44.

[54]See Funabashi (1988), p. 47. Additional information from background interviews.

[55]Between the Volcker-Pöhl meeting and the announcement of the interest rate cuts, Volcker was very nearly forced into a unilateral reduction of U.S. rates. On February 24, four of the seven members of the Federal Reserve Board (dubbed the "Gang of Four") forced and won a vote over Volcker's opposition, to accept a cut in the discount rate from 7.5 percent to 7 percent. The four agreed to reverse the decision only after Volcker promised to seek the coordinated reduction that he had already negotiated in secret. See Volcker and Gyohten (1992), p. 274; and, for a contemporary news account, Kilborn (1986).

[56]According to Funabashi (1988), p. 20, the proposal from the G-5 deputies had been that Germany would be responsible for 25 percent of the intervention needed to bring about the desired realignment, with France carrying a 10 percent share. At the Plaza, however, the ministers and governors modified the plan to give the EMS countries a collective 35 percent share. Italy thus became involved as a member of the EMS. Earlier, Italy had participated in the coordinated intervention of February 1985 that had been initiated by the G-5 (see pp. 202–03, above).

1986, the prime minister, Bettino Craxi, was able to win President Reagan's support for the creation of a G-7 finance minister's group. Craxi had built up a measure of political capital with the United States by banning weapons sales to Libya in support of the U.S. trade embargo and by allowing NATO missiles to be based on Sicily. He also felt strongly enough about the matter to have a credible threat to withdraw altogether from the summit process if Italy continued to be excluded from the financial meetings.[57] Baker, alone among G-5 ministers, liked the idea of expanding to the full G-7, because it would link the ministerial meetings to the summit process and because it was likely to strengthen support for U.S. positions by bringing in Canada.[58] The G-5 ministers reluctantly approved the idea in April (subject to an informal agreement among themselves to continue to meet as the Five alongside the larger group), and the creation of the G-7 finance ministers was formally announced in the communiqué of the Tokyo summit conference in May.[59] Thus de Larosière's surveillance meeting with the G-5 ministers on April 8, 1986—the eighth such assembly in four years—was intended to be the last in this form.

Also around the beginning of 1986, both the IMF and the G-7 were developing responses to the reports of the G-10 and G-24 deputies on the functioning of the international monetary system. These responses would further strengthen the multilateral surveillance process, though without bringing about systemic reforms. Within the IMF, the Research Department prepared an evaluation of the two reports, which was discussed by the Executive Board on February 12.[60] As summarized in the staff study, the deputies' reports had identified three weaknesses in the existing system of floating exchange rates among the major currencies. First, exchange rates showed a high degree of short-term volatility. This factor was largely discounted by the Fund staff as a problem affecting the large industrial countries, since most of the economics literature showed that the real costs of short-term volatility were minor. The study recognized, however, that volatility might be a more serious concern for smaller enterprises and for developing countries with less access to international capital markets. Second, and of more general importance, exchange rates were subject to large and persistent misalignments, even though the extent of those misalignments could not be accurately gauged. Third, the absence of a real system had contributed to a lack of discipline and coordination in macroeconomic policies.

[57]See Lawson (1992), p. 543 for one account of the pressure that was applied.

[58]Baker later noted in his memoirs that he "took special pride" in the move (Baker, 1995, p. 604). Most participants, however, concurred with Geoffrey Howe that the expansion caused the group to lose "its secrecy and its intimacy (and quite a bit of its effectiveness)" (Howe, 1994, p. 266). Dobson (1991, p. 45) cites an additional cost: the occasional need for interpretors as the increase in the number of participants made it less likely that everyone would be able to work comfortably in English.

[59]"The Heads of State or Government . . . request the Group of Five finance ministers to include Canada and Italy in their meetings whenever the management or improvement of the international monetary system and related economic policy measures are to be discussed and dealt with . . ." (Hajnal, 1989, p. 313).

[60]See Morris Goldstein, "The System of Floating Exchange Rates: Review and Assessment," Chapter I in Crockett and Goldstein (1987). The internal version of the paper was "Review and Assessment of the System of Floating Exchange Rates," SM/86/5 (January 10, 1986).

The G-10 and G-24 reports had broadly agreed on the desirability of greater stability of exchange rates but had recommended different approaches to achieve that goal. The G-24 report concluded (Crockett and Goldstein, 1987, Appendix II, para. 66) that "target zones for the exchange rates of major currencies could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances." In contrast, the G-10 report (op. cit., paras. 31–32) concluded that, although *some* participating deputies believed that "credible commitments to target zones would contribute to stabilizing market expectations and would promote greater international policy consistency by reinforcing multilateral surveillance," the majority agreed "that the adoption of target zones is undesirable and in any case impractical in current circumstances." The G-10 deputies could agree only on marginal tinkering, such as asking (para. 51) that the IMF's *World Economic Outlook* (WEO) include a separate chapter "analyzing the international repercussions of national policies of Group of Ten countries and of their interaction in the determination of exchange rate developments and international adjustment."

In light of these conflicts, the IMF staff study concentrated on proposals for strengthening multilateral surveillance that could be carried out within the existing system. In particular, the staff revived its 1985 suggestion (see above, p. 204) for adoption of a system of "objective indicators" of economic policies and performance, which could be used both as the basis for a separate WEO chapter and as a means of focusing discussions with the major industrial countries (individually and jointly). The indicators could be grouped into measures of the stance of macroeconomic policies, of national economic performance, and of the linkages between the two. If agreement could be reached on a concise list of indicators, then surveillance could aim at discussing goals and reviewing the record on how well those goals had been met. If that approach proved to be useful, then target zones for exchange rates could emerge as a natural extension.

The Executive Board discussed the deputies' reports and the staff analysis on February 12, 1986.[61] Just the week before, the possibility of systemic reform had apparently been given a fresh boost through a surprise announcement in President Reagan's State of the Union address. After citing the crucial importance to the U.S. economy of "reliable exchange rates" and noting that the United States had "begun coordinating economic and monetary policy among our major trading partners," the President announced that he was "directing Treasury Secretary Jim Baker to determine if the nations of the world should convene to discuss the role and relationship of our currencies." Although once again nothing would come of the proposal (which had not been discussed previously within the G-7)—and this speech would turn out to be the last forum in which the idea of a new Bretton Woods would surface officially in the 1980s—it did help create a climate in which reform seemed possible.

The Executive Board meeting helped to clarify countries' views and to narrow some differences, though it did not reveal enough agreement to produce any immediate changes in the conduct of surveillance. The favorable attitude of the G-24 re-

[61]Minutes of EBM/86/25–26 (February 12, 1986).

garding target zones was explained by Yusuf A. Nimatallah of Saudi Arabia and by Pedro Pérez of Spain, who suggested that developing countries were adversely affected by exchange rate volatility to a much greater degree than were industrial countries that had ready access to sophisticated financial markets.[62] Without denying the importance of stability, however, Directors from G-10 countries emphasized policy coordination over systemic reforms as the best means to achieve it. Bernd Goos (Germany) regarded objective indicators as "mechanically imposed external constraints"; Hirotake Fujino (Japan) stressed the imprecision inherent in assessing equilibrium levels of exchange rates;[63] Jacques de Groote (Belgium) suggested that "target zones" should be replaced by the less precise but in his view more practical notion of "target directions"; and both Timothy P. Lankester (United Kingdom) and Marcel Massé (Canada) recalled that their own countries had found exchange rate flexibility to be a necessary part of their ability to absorb external shocks. Dallara—now representing the Baker Treasury and expressing more internationalist views than he had just a year earlier (see p. 205, above)—was alone among the G-10 representatives in making the case for a more systemic use of indicators. "Objectives relating to several key economic variables could help focus attention," he argued, and could "serve as an indication for policy action in particular areas and/or international consultation."

The next week, the Board again took up the indicators idea during the regular biennial review of the principles of surveillance. Members' positions on these issues had not changed, but this meeting provided an opportunity to examine specifically how the ideas in the deputies' reports might be taken on board in the conduct of surveillance. Dallara, making the opening intervention of the meeting, requested adoption of the G-10's suggestion for a separate chapter in the WEO, which could present and analyze a well-defined set of indicators for the major industrial countries. Although this recommendation was much weaker than other proposals for implementing a system of objective indicators—let alone target zones for exchange rates—it was nonetheless embraced by G-24 as well as G-10 executive directors as providing the Board a framework within which to discuss the international repercussions and interactions of the policies and objectives of the major countries.[64] In April, the general notion of formulating a set of objective indicators on which to base multilateral surveillance and the specific proposal of examining the indicators in the WEO exercise were formally endorsed by the Interim Committee (communiqué of April 10, 1986, paragraph 6).

[62]Empirical evidence tended to support that perception; see Chapter 2, footnote 33, p. 83.

[63]Speaking for the staff, Andrew Crockett suggested that it was reasonable to think in terms of a range of ±10 percent around an estimated equilibrium rate. Fujino, however, noted that empirical studies of the yen-dollar rate had put the equilibrium at levels ranging from 143 to 210 (compared with its then-current level of 185). The difference in view may be attributed to methodology. Estimates in the neighborhood of 210 were derived from calculations of purchasing power parity (Japan then being a high-price country for consumers), while those in the lower range were derived as the rates needed to establish equilibrium in external current account balances (Japan then being a low-cost country for producers).

[64]This characterization is given in the Chairman's summing up; minutes of EBM/86/30 (February 19, 1986), p. 49.

The United States also pushed the G-7 to adopt a system of objective indicators for its own work. Mulford saw the indicators approach to surveillance as a means of shifting the focus of G-5 meetings away from U.S. fiscal policy and toward a more general and balanced discussion of the requirements for medium-term stability. He first sold Baker on the idea, and then persuaded the other G-7 deputies that this was the most they could expect to agree on as a means of promoting stability and coordination. Following the surveillance meeting with de Larosière on April 8, 1986, the G-5 ministers approved the plan in principle. It was then formally endorsed at the Tokyo summit in early May:

> . . . the Heads of State or Government . . . With the representatives of the European Community:
>
> – Reaffirm the undertaking at the 1982 Versailles Summit to cooperate with the IMF in strengthening multilateral surveillance . . . and request that, in conducting such surveillance and in conjunction with the Managing Director of the IMF, their individual economic forecasts should be reviewed, taking into account indicators such as GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates; [and]
>
> – Invite the Finance Ministers and Central Bankers in conducting multilateral surveillance to make their best efforts to reach an understanding on appropriate remedial measures whenever there are significant deviations from the intended course; and recommend that remedial measures focus first and foremost on underlying policy fundamentals, while reaffirming the 1983 Williamsburg commitment to intervene in exchange markets when to do so would be helpful.[65]

On paper, this agreement on indicators was innocuous even by the standards of summit communiqués. In practice, however, it represented a step forward from the even more timid approach adopted just a few months earlier by the Executive Board, and it intensified collaboration between the IMF and the G-7. In effect, the Fund staff would become an informal secretariat responsible for preparing and analyzing the objective indicators on which multilateral surveillance was to be based. That function would extend the IMF's participation beyond the Managing Director's meetings with ministers to include staff participation in the deputies' preparatory work for those meetings. Since the most substantive decisions often were agreed upon initially by the deputies, involvement in those deliberations was potentially more valuable than the existing higher-level participation.

Shortly after the Tokyo summit, the G-5 deputies asked the Managing Director to offer suggestions on the role that the IMF might play in implementing the new indicators process. In early June, de Larosière circulated a proposal to the G-7 deputies[66] that called for Fund involvement in three of the four stages of the process:[67]

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[65]See Hajnal (1989), p. 295.

[66]Several more months would elapse before the deputies from Canada and Italy would be fully integrated into the preparations for the surveillance meetings of finance ministers.

[67]"Note on the Use of Indicators in Surveillance Discussions of the Group of Five and Group of Seven" (June 11, 1986), in IMF/RD Managing Director file "Group of Seven" (Accession 88/285, Box 5, Section 250).

- to put national forecasts for key data on a comparable basis, including projecting variables not normally forecast by the authorities and ensuring that the assumptions underlying the forecasts were reasonably consistent;
- to identify and assess any remaining inconsistencies in the forecasts and ways in which the projections might be undesirable or unsustainable; and
- to suggest policy options for correcting inconsistencies and getting economic performance back on a sustainable path.

On the basis of that background work, the ministerial meetings could aim more clearly at making choices among the available policy options.

On a more technical level, the IMF also undertook to identify a concise but comprehensive set of indicators and to develop a clear framework for presenting them, both in the WEO and in the tables and charts prepared for ministerial meetings on surveillance. Meeting for this purpose in July 1986, the Executive Board cautiously agreed on a few basic circumscribing principles. First, it was agreed that if the indicators approach was to have any meaning at all, the chosen indicators would have to be "limited in number, quantifiable, timely, relatively easy to interpret, and comparable from country to country." Second, the development of such indicators should be viewed as an aid for a broadly based judgmental analysis, not as an end in itself. And third, the whole exercise would be useful only if the countries concerned displayed the political will to respond to it. That last requirement, of course, was understood to be a most difficult—and possibly insurmountable—hurdle.

The Board also broadly endorsed the staff's proposal that the requisite analytical framework be developed around national saving-investment balances. The intention of this proposal was to emphasize the linkages between domestic monetary and fiscal policies and external current account balances.[68] As the staff paper for the meeting put it (Crockett and Goldstein, 1987, p. 36),

> . . . if judgments are required concerning whether a given pattern of exchange rates is to be regarded as sustainable or desirable . . . [a] logical place to begin is by looking at the factors that influence the balance of domestic savings and investment (and therefore the net acquisition of foreign assets [i.e., the country's current account balance]. . . . Indicators that may be useful in this context include: (1) a measure of the overall fiscal position; (2) gross private savings flows; (3) gross private investment; and (4) real interest rates.

Although this description allowed fully for flexibility in application, it provided a framework for linking the "twin deficits" (fiscal and external) of the United States and the corresponding strong fiscal positions and external surpluses in Germany

[68]Modern theory linking current account balances to monetary and fiscal policies through the national saving-investment balances originated with Meade (1951). Bruno (1979) and Sachs (1981) developed influential analyses based on this approach, and Frenkel and Razin (1987) developed the model to its fullest and most rigorous extent. For the initial proposal to base the development of indicators in the Fund on the saving-investment approach, see "Objective Indicators," memorandum from James Boughton to Andrew Crockett (April 23, 1986), in IMF/RD Research Department Immediate Office file "Correspondence Originated by ADC, 1986 (Accession 89/263, Box 1, Section 49).

and Japan. The Executive Directors from the latter two countries, and a few others, expressed concern lest too strong a correlation be assumed between fiscal policy and external imbalances, and lest too much emphasis be given to external objectives in the implementation of fiscal policy. Nonetheless, the Board endorsed this saving-investment approach as a good way to focus on the main issue, which was keeping external imbalances from getting too large for too long.[69]

The G-5 deputies met once more over the summer to refine the approach that they intended to take, and then for the first time invited the Fund staff to participate in their next meeting, the third since the Tokyo summit and the one where the agenda would be prepared for the regular fall ministerial meeting on surveillance.[70] The deputies would be meeting in Paris on this occasion, at the secluded site of the Pré Catalan restaurant in the Bois de Boulogne. As with the Managing Director's participation in ministerial meetings, the IMF staff representative (Andrew Crockett, Deputy Director of the Research Department) was invited only for the first part of the meeting, after which the deputies were to turn to the task of drafting the ministerial communiqué.

This development of the indicators approach to surveillance in the second half of 1986 took place against the backdrop of a continuing slowdown in economic growth in the large industrial countries and, consequently, additional efforts within these countries to engineer further reductions in interest rates.[71] Following the cuts implemented in March, Volcker was prepared to push U.S. interest rates down further. However, he feared precipitating a flight out of dollars and therefore was reluctant to cut rates without some assurance that other central banks would follow suit. Throughout the summer, he and Baker tried without success to win such an agreement from their counterparts in Germany and Japan.[72] The German authorities resisted with particular firmness out of concern that further cuts in German interest rates would merely fuel price inflation.

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[69]Minutes of EBM/86/114–15 (July 14, 1986). As noted in Chapter 5, the staff continued to develop and refine the empirical application of the saving-investment approach, and on two occasions in 1987 the Board further endorsed this line of analysis, both for the G-7 exercise and the WEO. See "Enhancing the Use of Indicators as a Tool for Surveillance," EBS/86/282 (December 18, 1986), "The Use of Indicators in Surveillance—Analytical Issues," EBS/87/135 (June 24, 1987), and the minutes of EBM/87/8–9 (January 14, 1987) and EBM/87/105–106 (July 22, 1987).

[70]The invitation for the Fund staff to participate in the deputies' meeting was conveyed by Mulford to de Larosière around the beginning of July, on behalf of the G-5 deputies. Memorandum to files by Andrew Crockett (July 7, 1986); in IMF/RD Research Department 1986 Chronological file (Accession 89/263, Box 2, Section 49).

[71]In retrospect, the slowdown in real GDP growth in the G-7 countries as a whole had been modest: from a peak of 4.7 percent in 1984 to 2.9 percent in 1986. Moreover, the slowdown was already being moderated by declining long-term interest rates: from 11.4 percent to 7.7 percent over those two years. The concern, however, was not misplaced, because the U.S. fiscal deficit had not yet been cut significantly; hovering around 4¾ percent of GDP, such an imbalance made a sustainable recovery all but impossible. It was to limit the resulting pressure on capital markets that attention was being directed to the use of monetary policies to reduce short-term interest rates.

[72]See Funabashi (1988), pp. 53, 156, and 168–69; and Volcker and Gyohten (1992), p. 264. In addition to the secret meetings described in those accounts, private discussions took place at the monthly central bank governors' meetings at the BIS in Basel, Switzerland.

Partly because of this frustration and partly because of the normal stress of international negotiations, the atmosphere had become quite tense. There was suspicion among the deputies as each jockeyed to promote his own country's policies and proposals, suspicion of the Fund by deputies who saw it as an interloper in the club, and suspicion between Fund staff battling over turf.[73] Nonetheless, the Pré Catalan meeting gave a strong beginning to the Fund's role in the indicators approach to surveillance. One of the more delicate issues to be decided was whether the basic indicator tables for ministers were to be based primarily on national or IMF forecasts. The use of national forecasts would give the deputies more control but would force them to waste time trying to reconcile and interpret what would inevitably be inconsistent, country-specific, numbers. After hearing Crockett explain how the IMF staff would make and present its projections, the deputies agreed to base their work on the Fund's numbers and assessments.

The principal ministerial surveillance meeting—still restricted to the G-5—was scheduled for Friday, September 26, 1986, preceding the Annual Meetings in Washington. Armed with the newly slimmed-down indicators tables and charts, de Larosière argued that current policies being pursued by the three largest countries were incompatible. To get to a stable equilibrium over the medium term, external current account imbalances would have to be attenuated, the U.S. fiscal deficit would have to be further reduced, and Germany and Japan would have to act to stimulate growth of private sector demand.

As usual, no policy decisions were taken at the G-5 meeting (nor at the G-7 meeting the next day), but the discussions provided a framework for the ongoing bilateral efforts to coordinate policy actions. On the same weekend as the G-5 meeting, Baker pressed both Stoltenberg and the newly installed Japanese finance minister, Kiichi Miyazawa, to take stimulatory measures. Separately, Volcker made a similar plea with Satoshi Sumita, governor of the Bank of Japan.[74] Stoltenberg felt that he could do little to influence the fiercely independent Bundesbank, and in any case he regarded the recent increases in German interest rates as too slight to worry about. At the end of October, however, Baker's diplomacy paid off in the form of a joint declaration with Miyazawa that the two of them had "reached agreement on cooperative action and understandings regarding a number of issues of mutual concern." On the Japanese side, the agreed actions included submission of a supplementary budget with additional expenditure, proposals to reduce income tax rates, and—most immediately—a cut in the discount rate by the Bank of Japan. On the U.S. side, the communiqué listed only a previously enacted tax reform and vague commitments to reduce the fiscal deficit, resist protectionist pressures, and promote economic growth. Though singularly unbalanced, this agreement represented, in

[73]Because three of the G-5 countries are European, the Fund task force established after the 1982 Versailles summit had been chaired by Alan Whittome, Director of the European Department. With the expansion of the Fund's role (including a closer linkage to the World Economic Outlook) and the extension of the coverage to the G-7, much of the background work was now the responsibility of the Research Department.

[74]See Funabashi (1988), pp. 54 and 158; and Lawson (1992), p. 552.

principle, a genuine breakthrough. Without waiting for Stoltenberg to come around, Baker and Miyazawa had found a formula by which policies could be adjusted in the direction that de Larosière had asked for in September, without the potentially disruptive effects of uncoordinated shifts in interest rates.

Louvre, 1987

Within a few weeks after the Baker-Miyazawa communiqué, the G-5 was preparing for a ministerial meeting that—for all of its limits—would turn out to be the apogee of the policy cooperation process in the 1980s. Like the Plaza meeting that preceded it by 17 months to the day, the Louvre accord on exchange rates was planned and executed outside the aegis of the IMF, though it would be carried forward with the institution's support and cooperation. Stoltenberg, Baker, and their deputies met in Kiel, Germany, in November 1986 for the initial discussions of how to consolidate the progress in restoring a measure of stability in exchange markets. In light of the Baker-Miyazawa agreement, Stoltenberg had little choice but to bring Germany into the process, or he would risk seeing the deutsche mark appreciate against both the dollar and the yen and thus also risk losing the momentum of European recovery. From November 1986 through January 1987, Tietmeyer met on several occasions with other G-5 deputies, especially with Darman, and agreed with them to try to establish some limits on exchange-rate movements and to agree on the required policy adjustments to achieve that objective.

The IMF staff became peripherally involved when the deputies next met as a group, at the Dolder Grand Hotel in Zurich, on January 29, 1987. Crockett represented the Fund (for the second time) and participated through the afternoon as the deputies analyzed the indicators and how they fit into the economic outlook. After four hours of discussion, he was then asked to leave the meeting around 5 p.m., and the deputies continued their meeting through the evening and again over breakfast the next morning. Only among themselves did the deputies discuss policies to stabilize exchange rates.

Though the IMF staff was excluded from the deputies' planning for the meeting at the Louvre, the Managing Director was involved serendipitously by the exchange of jobs between de Larosière and Camdessus. (De Larosière left the Managing Director's post in January 1987 and became governor of the Banque de France on February 16. Camdessus was the governor as the planning for the Louvre conference began and became Managing Director in mid-January.) Officially, Camdessus's role as Managing Director at the G-5 ministerial meeting on February 21 was the same as the role previously played by de Larosière. On a personal level, he was more deeply and directly involved in the G-5 process, as he had been from his days as the French deputy at Versailles and thereafter (1982–84), through his time as governor (1984–87), which included the Plaza.

For the Louvre conference, Camdessus submitted a note that dealt more openly with exchange rates than had been customary. His message asserted frankly that the exchange rate movements that had already occurred had reversed much of the previous misalignment and had contributed to a narrowing of current account imbalances;

that slow growth in industrial countries had now become a major problem that was hurting developing countries as well; and that the solution to the problem lay partly in slowing the pace of fiscal consolidation in some countries, especially Germany and Japan, and partly in structural reforms such as deregulation and privatization.[75]

The finance ministers, their deputies, and the central bank governors of the G-5 met at the Finance Ministry offices in the Palais du Louvre at 3 p.m. Saturday (February 21, 1987) for the now-customary surveillance discussion with the Managing Director. In his oral presentation to the ministers, Camdessus amplified the points made in his position paper by arguing that the risks of recession and protectionism now outweighed the risks of rekindling inflation, and that the success of the debt strategy required a resumption of sustainable growth in the major industrial countries. Following that kickoff session, the G-5 participants (without official IMF representation, but with de Larosière serving as what one participant has called "the ghost of the IMF") met for several more hours through dinner ("while all the participants were quite busy cutting their meat and sipping their wine")[76] to decide how to get better stability. Finally, they agreed not only that the then-current level of exchange rates was about right, but also that they should consult with one another if the dollar-yen or dollar-mark rates were to move beyond specified limits.[77]

Beyond the commitment to consult, what was agreed among the participants at the Louvre is in dispute. Some interpreted the meeting as establishing a system of target or reference zones for exchange rates, while others insisted that the ranges were only indicative. As an interesting twist on the systemic debates of the 1970s and early 1980s, the U.S. delegates, Baker and Volcker, were now teamed with the French side, Balladur and de Larosière, in arguing for close and comprehensive control through a combination of exchange market intervention and underlying policy actions. The Japanese and especially the German delegates resisted firm agreements and later interpreted the accords as nonbinding and flexible.[78] The British were in a delicate spot because the chancellor, Nigel Lawson, was on record as being much more hawkish for exchange rate stability than was his prime minister, Margaret Thatcher. The U.K. delegation went along with the ranges for the other currencies but insisted that no range be set for the pound sterling.[79]

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[75]Memorandum from the Managing Director to G-7 Executive Directors (February 19, 1987); in IMF/RD Deputy Managing Director file "G-5" (Accession 91/455, Box 4, Section 489).

[76]Gyohten, in Volcker and Gyohten (1992), p. 268.

[77]Two midpoints were specified: 1.825 deutsche marks per dollar, and 153.5 yen per dollar. There was to be an allowed inner range of ±2.5 percent for each rate, and an outer range of ±5 percent. See Funabashi (1988), pp. 183–87; Lawson (1992), pp. 554–55; and Volcker and Gyohten (1992), pp. 267–68 and 282–83. This use of a soft inner and a hard outer range echoed the 1972 Volcker-Daane proposal for reserve indicators (see footnote 45, p. 204).

[78]The Bundesbank was particularly adamant in its insistence that no binding commitments had been made. Pöhl (1987) characterized the accord as a "commitment by the U.S. to cooperate in efforts to stabilize the dollar against the yen and the deutsche mark. . . ."

[79]At the time, the United Kingdom was a member of the EMS but did not participate in the system's exchange rate mechanism. The pound was floating relative to all of the other G-5 currencies. A separate range for the French franc would have been redundant, as it was already linked to the mark via the narrow (2.5 percent) band of the EMS.

These substantive differences in view within the G-5 were overshadowed at the time by a public turf battle waged on Sunday by the Italian delegation. Just over a year had passed since the original agreement to invite Canada and Italy to join the surveillance process, and the insistence of the G-5 on holding substantive councils before each G-7 meeting was becoming more and more irritating and embarrassing to Italy. The Italian delegation to the Louvre attempted to secure a compromise under which all seven countries would be invited to the working dinner on Saturday as well as to the concluding meetings on Sunday, but that strategy failed when the Canadian team indicated a willingness to remain on the sidelines. After dinner Saturday evening, Balladur and de Larosière visited Giovanni Goria, the Italian Minister of the Treasury, at his suite at the Hotel Meurice, just three blocks down the rue de Rivoli. They briefed him on the day's developments and tried but failed to persuade him to participate on Sunday.[80] The Italian delegation returned to Rome the next morning without visiting the Louvre, and when the February 22 communiqué was released—following a 9:30 a.m. meeting of all other delegations, including Camdessus on behalf of the IMF—it was issued on behalf of the other six members of the G-7.

The immediate effect of this stormy episode was to clear the air after several long months during which the G-5 had attempted to preserve the intimacy (and thereby, in the view of most of them, the effectiveness) of their club despite the formal acceptance of the wider membership. The G-5 met once or twice more at the ministerial level in the course of 1987, after which Canada and Italy became more fully involved.[81] By that time, however, the whole process had begun to bog down. What had started in the 1970s as private gatherings of four or five people had now evolved into closely watched conferences involving more than twenty active participants, numerous aides restlessly prowling the corridors outside, and packs of journalists in search of a good quotation. The process could still provide a useful forum for multilateral surveillance, but (regardless of whether five or seven countries were involved) it had also become a symbol of the pitfalls inherent in any attempt to establish a mechanism for international policy coordination.

Life After the Louvre: 1987–89

Two days after the Louvre meeting, Camdessus reported to Directors his impressions of the event. He stopped short of stating that the Group had entered into a secret agreement to stabilize exchange rates, but he spoke warmly of the enhanced commitment to coordinate policies so as to keep exchange rates around

[80]As it happened, the persuasion effort was hopeless because Goria had already received firm instructions from Rome not to accept this compromise.

[81]As noted by both Funabashi (1988, pp. 206–207) and Lawson (1992, p. 555), the G-5 met at the ministerial level in April 1987 to realign the target rate for the dollar-yen exchange rate. The Managing Director was not invited to that meeting, but he did participate in the G-7 meeting the next day. The G-5 deputies met at least once later that year, but in subsequent meetings Italy and Canada became full participants at all levels.

current levels. Arjun Sengupta (India) pressed unsuccessfully for a staff study on whether G-7 exchange rates really were "broadly consistent with underlying economic fundamentals," as claimed in the Louvre communiqué, but the general reaction was more supportive.[82]

Whatever its shortcomings, the Louvre meeting marked the extent of maturation of the multilateral surveillance process and of the Fund's supporting role. Although three more summits and a half dozen ministerial meetings were held before the end of the 1980s, the process underwent little additional deepening.[83] From the surveillance perspective, the most important remaining summit was held in Venice, just four months after the Louvre. The Venice communiqué not only endorsed the Louvre agreement to keep exchange rates near current levels. It went further by distancing the G-7 from reliance on changes in exchange rates as an instrument for adjustment: "Exchange rate changes alone will not solve the problem of correcting [external] imbalances while sustaining growth." Surplus countries, the leaders concluded, needed to "strengthen domestic demand," while countries with external deficits needed to reduce fiscal deficits. Of more direct relevance to the Fund, the communiqué also suggested that the indicators process could be strengthened considerably. It called for the G-7 to develop a "mutually consistent" set of "medium-term objectives and projections" and for the periodic assessment of economic performance based on indicators "in cooperation with the Managing Director of the IMF" (paras. 5, 11, and 12; see Hajnal, 1989, pp. 333 and 335–36).

The Venice initiative led to an increase in scope and detail in the indicators tables prepared by the staff as background for the G-7 meetings. It also seems to have emboldened Camdessus, who soon made a much more direct pitch for exchange rate action than he ever had before. At a Washington meeting of the G-7 in September 1987, he told the finance ministers and central bank governors that the current levels of exchange rates (which were still close to the levels approved at the Louvre or in Washington two months later) were not appropriate, based on current macroeconomic policies. Even if policies were adjusted in the appropriate direction (more saving in the United States and more stimulus in Germany and Japan), exchange rate movements would still be needed. At the end of the meeting, however, the G-7 reaffirmed its support for the already agreed levels.

The complacency of the G-7 was shaken but not shattered by the stock market crash of October 1987. For four days before the crash, Baker sharply and openly criticized the German authorities (in effect, the Bundesbank) for raising interest rates, which he viewed as a violation of the spirit of the Louvre and other G-7 agreements. One never knows what causes a sudden shift in asset prices, but the combination of Germany's actions and Baker's remarks must have contributed sig-

[82]Minutes of EBM/87/31 (February 24, 1987), pp. 1–5.

[83]Saccomanni (1988) argued that the process failed to mature because it lacked institutional structure. He proposed creation of a major-country "multilateral surveillance council," to be chaired by the Managing Director, as a way to perpetuate the process. Dobson (1991), Chapter 6, offered a comprehensive set of proposals for strengthening the process, including a stronger institutional role for the Managing Director and the Fund.

nificantly to the severity of the decline.[84] The crash then triggered a flurry of unscheduled G-7 activity, including informal meetings between finance ministers and Camdessus at which the Managing Director urged everyone to continue to support the U.S. effort to reduce its fiscal deficit, not least because of the contribution that it would make to the stability of exchange markets.[85] The deputies met two or three times over the next several weeks to organize a ministerial meeting in December. Jacob A. Frenkel (Economic Counselor and Director of Research) participated in the final planning session, in Paris on December 9, and before that he and Crockett met individually with deputies in Tokyo, Bonn, and London. Throughout this period, however, Baker was preoccupied with trying to get the U.S. Congress to approve the government budget for fiscal year 1988 and end a stalemate that temporarily shut down much of the federal government. So the G-7 did not meet, but—uniquely—they issued a communiqué anyway, just before Christmas and immediately after congress finally approved the U.S. budget. This statement again confirmed the continuation of the Louvre strategy and warned especially against a depreciation of the dollar:

> . . . either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process, could be counterproductive by damaging growth prospects in the world economy.[86]

This carefully crafted asymmetry was repeated word for word in the next G-7 communiqué, issued after the April 1988 ministerial meeting, and again in the communiqué of the Toronto summit meeting two months later. Throughout those six months, the dollar appreciated strongly against the mark and more moderately against the yen, as the G-7 resisted pressure from the Fund and most independent analysts for exchange rate adjustments in the opposite direction.

On a more analytical note, the Fund and the G-7 continued to refine the indicators process. Beyond the expansion of the medium-term performance indicators after the Venice summit, consideration was given to two other innovations.

First, at the April 1987 meeting of the Interim Committee, Baker asked the Fund to develop a consistent set of "structural" indicators. What he particularly had in mind was a means of measuring rigidity in national labor markets. U.S. officials be-

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[84]Baker's initial criticism was made at a White House press briefing on Thursday, October 15. On Friday, the Dow-Jones Industrial Average—which already had been declining gradually—fell sharply, by 108 points (4.6 percent). Baker repeated his criticism throughout the weekend, and on Monday the stock average fell by 508 points (22.6 percent). After Baker met with Stoltenberg and Pöhl over lunch in Frankfurt that same day, and the three issued a reconciliatory statement to the press, the controversy quieted down. Perhaps coincidentally, stock markets quickly began to recover. Camdessus later told the G-7 ministers that their public disagreements over interest rate policy had not only contributed to the crash but had threatened the credibility of the policy coordination process. See "G-7 Speaking Notes," memorandum from Frenkel to the Managing Director (March 29, 1989); in IMF/RD Managing Director file "G5/G7, January–June 1989" (Accession 1990-0079, Box 2, Section A).

[85]Report by the Managing Director at EBM/87/156 (November 17, 1987).

[86]Statement circulated to Executive Directors as "Statement of the Group of Seven," EBD/87/338 (December 23, 1987).

lieved, no doubt correctly, that European labor markets were much less flexible than those in North America and that this rigidity went far toward explaining the relatively weak job growth in Europe throughout the 1980s. If so, this structural gap could help explain the persistence of external imbalances within the G-7. The Fund staff prepared a report on the problem and concluded that rigidities in labor and other markets could not readily be compared between countries because of the great variety of experiences in this regard. Structural policies were discussed by the Executive Board in January 1989, and the staff papers were subsequently published (Bayoumi and others, 1989; Feldman and others, 1989; Wattleworth and Woglom, 1989), but the idea of developing an operational set of structural indicators quietly died.[87]

Second, there was the curious case of the commodity price indicators. In October 1987, the Interim Committee urged the Fund to refine the indicators further, and both Baker and Lawson made specific proposals in their Annual Meetings speeches for the use of an index of global primary commodity prices as an indicator of overall price movements. This idea—adding an indicator of commodity prices to a table of economic data—may seem trivial, but it was introduced to overcome a serious limitation of the G-7 surveillance exercise. Now that the process was focused primarily on maintaining a given pattern of exchange rates—a goal that required a measure of coordination of monetary policies—the participating countries risked losing control of the price level. Any set of exchange rates could be made consistent with any price level and any rate of inflation. Furthermore, none of the G-7 countries was a clear choice to serve as a numeraire for the system. German officials were reluctant to let the largest country take the lead, because the United States had a higher inflation rate than Germany was prepared to accept, and U.S. officials were unwilling to subjugate their own policies to any other country.

The fact that the U.S. and U.K. ministers made similar proposals simultaneously reflected the close working relationship between them, but the two proposals reflected subtle differences in rationale. Lawson stressed the potential for commodity prices to serve as a nominal anchor and to help "ensure that there is no inflationary (or for that matter deflationary) bias for the group [of major industrial countries] as a whole." Baker suggested a less directly operational role and noted only that commodity prices could serve as a leading indicator of more general price developments ("an early warning signal of potential price trends").[88] Baker nonetheless created a furor in the press and among analysts by specifically mentioning only one commodity: gold. To many, it seemed as if the U.S. government was testing the waters to see if the stuff of so much legend, discarded from the world's monetary systems no more than a decade earlier, could now be resurrected. In retrospect, however, it became clear that gold was included primarily to excite domestic political passions.[89]

[87]The Board discussion was at EBM/89/3–4 (January 13, 1989).

[88]IMF, 1987, pp. 92 (Lawson) and 108 (Baker). A few weeks later, Pöhl publicly endorsed the modest "early-warning" version and rejected the stronger "anchoring" version; see Pöhl (1987).

[89]For a sympathetic press report, see Fossedal (1989). Frankel (1994, p. 321) suggests that Baker included gold in his proposal to "outflank" U.S. Representative Jack Kemp, who was running for president on a platform that included returning the United States to a gold standard.

Again the staff duly set to work to study the problem.[90] The report, which was discussed by the Executive Board in January 1988, concluded that commodity prices could serve usefully as a supplementary leading indicator of major shifts in inflationary pressures. The report, however, threw cold water on the notion that stability in commodity prices would lead predictably to overall price stability. It thus found favorably for Baker's modest proposal but was less positive concerning Lawson's more ambitious goal. Executive Directors, for the most part, were more skeptical but were receptive to the suggestion that commodity prices should be featured more prominently in the World Economic Outlook.[91]

Separately, the staff assisted the G-7 in developing a pair of new indices of commodity prices "including gold" (with and without oil) specifically for the policy coordination exercise, with prices measured in SDRs. As it happened, the weight on gold was small enough and gold prices were highly enough correlated with other commodity prices that changes in the price of gold never had a substantive impact on the behavior of these indexes. The addition of the indexes to the surveillance process was considered important enough to be mentioned in the communiqué of the Toronto summit, held in June 1988. The G-7 then began regularly looking at commodity prices at their semiannual meetings, but the indices never were elevated to a central role.

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[90]The present author had primary responsibility for the report on commodity prices. The technical analysis, prepared jointly with Professor William H. Branson of Princeton University, was published in a series of papers; see especially Boughton and Branson (1990, 1991).

[91]"Commodity Price Baskets as Possible Indicators of Future Price Developments" SM/87/291 (December 11, 1987), and the minutes of EBM/88/4 (January 11, 1988) and EBM/88/7 (January 15, 1988).

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