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TRENDS IN THE INTERNATIONAL FINANCIAL SYSTEM

Raymond Barre

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I Opening Address

S. Rajaratnam

Your Excellency, Prime Minister Dr Raymond Barre, Mrs Barre, Ladies and Gentlemen.

Of the seven distinguished speakers including Dr Barre who have so far been invited to deliver the Singapore Lecture, three have been eminent economists. It is a measure of our preoccupation, you might even call obsession, with economic problems. This is understandable because, despite the confident assurances of our political leaders that everything is for the best in the best of all possible worlds, we non-economists have an uneasy feeling that our leaders are really in charge of a run-away world economy, and possibly do not know it — which is a probable basis for their undeterred optimism. That is why people are turning more and more to economists rather than politicians for enlightenment and deliverance. Unfortunately, even when economists offer explanations, there are as many explanations as there are economists. However, I know that one of the explanations must sooner or later be right. Because if all of them were wrong, then the only conclusion one can draw is that the end of the world is in sight, which is absurd. Fortunately, I am not a man easily given to despair because as a politician, I must — for my own credibility with my voters — exude unshakeable optimism. So, I am optimistic that sooner or later I would have occasion to come across an economist who would clear for me the confusion current among economic philosophers.

Many years ago, I read the play *Waiting for Godot* by Samuel Beckett. The play revolves around two tramps who could not understand why life for them should be one of unrelieved hunger, cold, and pain. During the play they vacillate between hope and despair. They are dominated by the absurdity of life and are obsessed by its uncertainties. Yet they persist in believing that behind these uncertainties, ambiguities, and absurdities, there must be meaning and therefore hope. That is why in the play they are waiting for a Mr Godot who, they believe, can explain life's absurdities to them. The two tramps argue, sometimes angrily, about the inexplicable mysteries of life while waiting for Godot. It is not clear whether in fact a Mr Godot exists or that the tramps have even invited him. Towards the end of the play, a young boy, claiming to have been sent by Godot, arrives with the message that Godot cannot come that night but will do so the next night. Again, the next night Mr Godot does not turn up. The two tramps become angry and decide that, if Godot is not ready to save them, then they will just forget him and do the logical thing — commit suicide. They get up from the bench to walk away, but as the final curtain comes down, they are shown standing still as though rooted to the ground. They cannot walk away because they still believe that if they only wait long enough, sooner or later Godot must come. Not to believe in this is to destroy themselves.

I myself believe there is a Godot waiting somewhere. That is why we have invited a third economist to come and explain to us the seeming absurdities of contemporary economics, a sort of waiting for Dr Barre. However, I do not expect Dr Barre in a single lecture entitled "Trends in the International Financial System" to clear all our doubts and fears about the international financial system. But his intellectual background and practical experience in human affairs assures me that when we leave this lecture hall tonight we will be wiser and more reassured than when we came in. This is because he is an embodiment of the platonic ideal of a philosopher king. His list of attainments is so formidable that I can only mention a few of them. He obtained a first degree in Law and then postgraduate degrees in Economics, Business Law, and Public Law from the Institute of Political Studies in Paris. He has held professorships in many prestigious institutions of higher learning. He has served as a member in many committees set up to advise the French Government on investments and economic planning. He has served as Vice-President of the European Community responsible for economic and financial affairs, and has been a member of the General Council of the Bank of France. He has at various times been Minister of Trade and Minister of Economy and Finance. He has twice been Prime Minister of France. He has written several notable books on politics and economics. He is currently a member of parliament though, since he is still a young man of 62 — I understand respectable Frenchmen do not consider themselves old until they are at least over 90 — I do not expect Prime Minister Barre (in France, once you are a Prime Minister you retain the title for the rest of your life) will remain an MP for the rest of his life, at least I hope not. I have now great pleasure in inviting Dr Raymond Barre to speak to us.

II Trends in the International Financial System

Raymond Barre

Excellencies, Ladies and Gentlemen.

I am very grateful to the Institute of Southeast Asian Studies and to its Director, Professor Sandhu, for the kind invitation to deliver the Singapore Lecture 1986. I thank the Senior Minister, Mr Rajaratnam, for introducing me with such witty and gracious words. Mr Minister, I am not Godot because I am here; I am an economist — but I do not know whether I am an optimist or a pessimist. I am an economist who has to face facts, and the facts are strong and problematic. I have had to face facts in the European Community, I have had to face facts as Prime Minister of my country. And based on my experiences, I feel that the main quality of an economist should be humility. He tries to solve problems but he is not sure to succeed. What is important is neither optimism nor pessimism, but lucidity. And I will try tonight to be lucid about the problems which I have chosen to discuss.

Firstly, let me say that I am honoured and pleased to address such a distinguished audience, in a country which, despite its small size, plays a very important role in this region under the leadership of its Prime Minister, Mr Lee Kuan Yew. It is an example of hard work, innovation, and adaptability. It has reaped the fruits of its continuous effort. May I express today, to Singapore, one of the dragons of South-east Asia, all my wishes for the same success in the future.

* * *

In the last fifteen years, the evolution of the international financial system — I define the financial system in its broadest sense as the financing of the world economy — has been characterized by important *structural changes* which are largely interrelated.

The stability of exchange rates has been upset by the collapse of the Bretton Woods system, itself provoked by the dollar crisis of the beginning of the seventies. Under the regime of floating currencies we

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have observed not only the volatility of exchange rates, but also their misalignments resulting from overshooting — over-appreciation, or over-depreciation. The necessity of achieving a greater stability in international monetary regulations has been frequently underlined. Yet the divergencies of economic policies and the magnitude of capital movements are big obstacles to the restoration of a durable system of fixed but adjustable exchange rates and even to the working of a system of target zones requiring co-ordinated interventions of the major central banks within mutually agreed margins of fluctuation of currencies.

Except for Great Britain and Spain, the countries of the European Community have decided to participate in the European Monetary System which appears in the present international financial system as a zone of relative stability. The working of the system has resulted in a greater convergence of economic policies of the member states. This convergence has led to orderly exchange rate realignments. Since its inception almost eight years ago, the European Monetary System has been useful for all participants. In periods of heavy U.S. dollar fluctuations, it has undoubtedly been advantageous in that a good deal of foreign trade — about 50 per cent for member states of the Community — has been carried out within a zone of comparatively stable exchange rates. But we must recognize that this system cannot be generalized now, mainly because the success of the EMS is linked to the fact that there is no big reserve currency in our European System.

During the last fifteen years, two other big changes have taken place in the international financial system. The United States, a net creditor in the world in the seventies, became a net debtor in 1985. The United States' foreign debt at the end of 1985 amounted to $120 billion and will rise under present conditions to $500 billion in the nineties — which means a big problem not only for the United States but also for the rest of the world. At the same time, Japan has become the main creditor country in the world. There is also the debt problem of developing countries. In spite of some improvement in the situation in recent years, this now appears as a long-term problem for which economic considerations cannot be dissociated from social and political considerations.

To complete the scenario, I would like to highlight the rapid *integration of financial markets* which presents three dimensions. The first dimension is the integration of exchange markets in the world. Exchange transactions have been globalized such that after the opening of the Auckland and Sydney markets on Monday morning until the closing of the U.S. markets on Friday afternoon, exchange transactions take place continuously, 24 hours around the world, with exchange rate movements in one market immediately affecting those in the market next to open. Such integration has been brought about by the remarkable improvement of telecommunications which has enabled us to gain access to exchange markets all over the world all the time. The second dimension of integration is the integration of interest rate movements. Interest rate movements in one country may affect interest rates in other countries. And it is not always easy to disconnect interest rates in one country from those in others unless those countries are willing to accept fully the possible adverse impact of interest rate differentials on exchange rates. The third dimension of integration is deregulation and innovation. The financial revolution which is developing largely in New York and London is spreading more and more to the financial communities of the markets. If the financial revolution can afford advantages, it can also become a factor of vulnerability for the international financial system. This broad-based picture shows that in the medium run we could have to face some dangers in the world economy which relate primarily to the financial system.

Let us examine three aspects of the international financial system that could constitute possible breaking points — the extent of current balance of payments imbalances and their influence on the evolution of exchange rates; the international debt problem, the greatest challenge of the present and the future; and the financial revolution which can affect the world's banking system. These aspects constitute a challenge for the economy and the responsible authorities. Effective and durable solutions must be found, yet this is not easy in the light of the many constraints on the economies and their increasingly complex interdependence.

I

Very large *imbalances* have risen between the industrial nations. The 1981–85 period was marked by a sharp divergence in fiscal policies among the three largest economies of the world: whereas budgetary deficits declined in West Germany and in Japan, the budgetary deficit in the United States widened substantially to reach $220 billion this year. In a country with a rising budget deficit, the financing for it must come from increased domestic private savings, or from reduced investment, or from increased foreign borrowing. The mechanisms which may bring about this additional financing are a rise in real interest rates and an appreciation of the exchange rate — which happened in the United States. In this country, private savings rose very modestly, an evolution contrary to the hopes of the supply-siders, which implemented a very important tax cut in 1981. Private investment increased strongly in response to fiscal incentives introduced in 1981. It was left to foreign financing to close the budget gap. In 1985, foreign borrowing by the United States amounted to more than half of the budget deficit. This year, the current balance of payments deficit of the United States will remain very high. The depreciation of the dollar relative to the Deutschmark, to the European currencies, and mainly to the yen which began in February 1985 and was accelerated by the Plaza Agreement in September 1985, no longer has a full impact on trade volumes. The J-curve effect of a devaluation explains why the U.S. trade deficit in nominal terms has not yet been reduced and at the same time why Japan and Germany are enjoying their highest surplus.

Two questions arise at this point of the discussion: Is the present rate of the dollar satisfactory? And can the devaluation of the dollar do the job alone? Relevant to the first question is whether the depreciation of the U.S. dollar has gone far enough. A positive answer is given by Paul Volcker who recently stated: "In contrast to the situation eighteen months ago, and assuming growing markets are open to us, my sense is that we are, for now, reasonably close to an appropriate adjustment in that area". The recent agreement between the monetary authorities of Japan and the United States tends to stabilize the dollar-yen exchange rate around 160 yen for one dollar. This rate is considered as conforming to the economic fundamentals. The president of the Bundesbank has expressed the same view on the present U.S. dollar level *vis-à-vis* the European currencies, that is to say, around two Deutschmark for one U.S. dollar. I understand their position. A further depreciation of the dollar could for Europe endanger, through the fall of exports, the process of economic growth which is now under way. It would also badly affect the Japanese economy. For the United States, a fall in the dollar would lead to increasing inflationary pressures and high interest rates without contributing much to a better trade balance. Moreover, the results cannot be reached without time lags which cannot be underestimated. For example, United States industries remain less export-minded than German or Japanese competitors. Many big U.S. companies manufacture abroad, thus they do not export. We should also not forget that important trading partners of the United States with substantial surpluses in their current account peg their exchange rate to the U.S. dollar or have devalued their currency relative to the dollar: Canada, some Latin American countries, or some Asian countries. For all these reasons, one cannot expect quick results. However, I am personally inclined to think that the present rate of exchange of the dollar is only temporary and that the fall of the dollar could continue in the forthcoming months. This view is not only mine but is shared by leading American experts. It is supported by two considerations: first the magnitude of the U.S. deficit and foreign debt which in the forthcoming years will incur annual servicing amounting to at least $40 billion.

I will try now to sketch an answer to my second question, that is, whether devaluation of the dollar alone can do the job. The United States urged its partners, mainly Japan and Germany, to stimulate their economies in order to increase domestic demand and consequently imports. In countries the growth of which is export-led and which have benefited from the rapid expansion of the United States in 1983-84, it appears necessary, in order to reduce international imbalances, to shift the determinants of expansion from foreign demand to domestic demand. But this proposition, according to which Europe and Japan should relax their monetary policies and increase public sector expenditure, is naive and dangerous. Were such a policy actually to be pursued, government and central banks would rekindle inflation and boost public sector borrowing. In this way, there could be a return to the imbalances we had at the end of the seventies and sooner or later we would be confronted again with a new painful adjustment process. Above all, this would reduce the rate of world savings in view of the capital required to finance technical progress and to keep up with population growth — this would be bound to damage the economic well-being of future generations.

The Europeans and mainly the EEC governments are convinced that the medium-term strategy, aiming at sustainable non-inflationary growth is a much better contribution towards more international equilibrium than returning to the stop-and-go policies of the past. Excessive preoccupations with the short term can sometimes undermine stability in the medium term. A steady course of policy is necessary to achieve fundamental economic objectives. It is all the more necessary that most European countries have to take account of this external constraint. They cannot create international money. They cannot borrow in their own money. They have to react by vigorous restrictive policies when there is a balance of payments deficit. An efficient medium-term strategy can yield results. In West Germany the entire growth of real GNP in the second and third quarters of 1986 was solely attributable to the domestic demand. The second quarter showed an increase of 5.5 per cent over the same period last year. In other words, domestic activities have so far proved strong enough to offset the dampening effect emanating from the external sector and the fall in the dollar. As for the German trade balance, the surplus in volume terms has already declined substantially — from January to August 1986 the volume of exports increased by only 1 per cent, imports increased at a rate of roughly 5.5 per cent. The German monetary policy is anything but restrictive — the money supply target will be significantly overshot this year.

As for Japan, the Maekawa Report shows big changes in mentalities and behaviour which will be necessary to reduce the role of the external sector in Japanese growth. This evolution has to be accepted by Japan if it wants to play its part in the harmonious working of the international economy and give up a rather mercantilist attitude. Such an evolution will take time. Countries with large balance of payments surpluses have a duty to sustain domestic demand growth at an adequate pace, that is to say, their policies should be compatible with the medium-term objectives of durable growth and financial stability. But the United States cannot be relieved of its responsibilities. The United States needs to carry out the plans put forward by the U.S. Administration and Congress to reduce the U.S. fiscal deficit. A major reduction of this deficit is needed if interest rates are to moderate further and if external imbalances are to be reduced in an orderly way. Moreover, efforts should be made to avoid a substantial decline of the dollar rate which would strongly affect the standard of living in the United States and would encourage protectionist measures that would in turn destroy the international economic system. Can the United States administration achieve such results within the last two years of President Reagan's mandate? Scepticism prevails. My conclusion on this topic is that effective co-operation and shared efforts are necessary if we want to overcome imbalances in the world economy. Budgetary and monetary policies will have to be pursued in the surplus countries in a way which would lead to efficient financing of the American deficit by resources coming from abroad.

II

The imbalances I have just analysed cannot be considered independently of *the international debt problem*. This problem cannot be restricted solely to servicing of debt as it is closely linked to the economic and financial equilibrium between nations. After the serious crisis of 1982–83, the international debt problem lost some of its acuteness. Thanks to restrictive measures adopted by the indebted countries, the rescheduling implemented by creditor countries, the upswing in the world economy and mainly in the United States, the most highly indebted countries were able to improve their external positions and thus pay the main part of their obligations. However, this improvement appears only temporary. Despite major reductions in world interest rates, the slow-down of the U.S. economy and weak growth in Europe and Japan have hit developing countries at a particularly bad time causing reduced output growth and a deterioration of most debt service indicators. Moreover, the fall in oil prices has caused a deterioration of the economic situation of some oil producers, like Mexico, through a strong drop in export earnings. At the same time, efforts made by debtor countries to reduce domestic imbalances and to deal with structural rigidities have notably

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