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International Liquidity Issues by Thomas D. Willett

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BOOK REVIEW

International Liquidity Issues. By Thomas D. Willett. Washington: American Enterprise Institute for Public Policy Research, 1980. Pp. 114. $5.25

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Casual browsing through Willett's latest study, *International Liquidity Issues*, is not for the timid.[1] This publication, one of American Enterprise Institute's series of studies in economic policy, reviews recent episodes in the evolution of international finance. Willett's contribution offers first a lucid defense of the managed floating exchange rate system, which has existed since the 1971 Smithsonian agreements, and, second, some suggestions for modest improvements in the existing system and the operation of the International Monetary Fund (IMF).[2] While the audience for these observations may be a small and largely technical one, it is also likely to be an influential one in light of Willett's experience and wide-ranging scholarship in this field.[3]

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1. T. Willett, International Liquidity Issues (1980) [hereinafter cited as Willett].

2. The IMF was formed in 1944 at the Bretton Woods Conference. Its principal architects were Lord Keyes of the British Treasury and Dr. Harry White of the United States Treasury. *See* E. Goldenweiser & A. Bourneuf, *The Bretton Woods Agreements,* Federal Reserve Bulletin, (September, 1944).

3. Thomas D. Willett, an AEI adjunct scholar and Horton Professor of Economics at Claremont Graduate School, has served as Deputy Assistant Secretary of the Treasury for International Research.

The introduction to the study assesses the developments of the early 1970's, which focused worldwide attention on the connection between the expansion of international liquidity, the amount of money in the world economy, and worldwide inflation.[4] Liquidity expanded rapidly at the time of the breakdown of the Bretton Woods fixed exchange rate arrangements.[5] The expansion was compounded with the huge increases in oil prices in 1973 and 1974 and the resulting enormous balance of payments surpluses of the OPEC countries. Willett concludes that these new realities require substantial rethinking of the issues surrounding international liquidity.

The second section of the study analyzes the emergence of current international liquidity concepts.[6] Willett begins by evaluating the degree to which economic concepts rooted in national monetary behavior can be generalized to explain international events. He finds the incentives and constraints operating on governments when controlling domestic monetary supply to be significantly different from those controlling their international monetary behavior, and thus of limited applicability.[7] Instead, one must focus on the unique institutions and incentives of the international system.

The study then describes these unique factors, starting with the liberal gold standard system that functioned during the latter part of the nineteenth century until 1913. Nations were committed to liberal trade policies, fixed exchange rates and the achievement of long-run equilibrium in the balance of payments through automatic adjustments. Countries running surpluses as well as those running deficits would be forced to adjust to restore equilibrium. In practice, of course, the extent, nature and rapidity of adjustment varied from country to country, situation to situation, but the theory was adhered to by all major players in the game.[8]

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4. Willett, *supra* note 1, at 1-5.

5. For a more introductory treatment of this and other international economic problems, *see* P. Samuelson, Economics 645-724 (10th ed. 1976).

6. Willett, *supra* note 1, at 6-75.

7. For contrary views on this conclusion *see, e.g.*, the discussions and references in M. Whitman, *Global Monetarism and the Monetary Approach to the Balance of Payments*, 3 Brookings Papers on Economic Activity 491-555 (1975).

8. For a further analysis of the actual operation of the gold standard during the nineteenth and twentieth centuries, *see* A. Bloomfield, Monetary Policy Under The International Gold Standard: 1880-1914 (1959).

After the First World War and during the interwar period, domestic macro-economic conditions more heavily influenced government policies, and the international monetary system became less automatic in operation. During the great depression of the 1930's each country tried to stimulate domestic employment through devaluation and protectionist trade policies, regardless of their international impact. As a result, world trade was crippled, and employment was reduced even further.[9]

After World War II, attempts were made to restore the system by institutionalizing the pressures to make exchange rate adjustments through the IMF, to restore respectability to the gold standard, and to prevent destructive trade practices through the General Agreement on Tariffs and Trade.[10] Exchange rates were not adjusted with as much frequency as expected, however. Official prestige became associated with maintaining constant exchange rates, and rigidities prevented the operation of the system as designed.[11] Thus the ground was prepared for the breakdown of the Bretton Woods agreements in the early 1970's.[12]

Willett then analyzes the causes of the liquidity explosion since the 1970's, and its impact on world inflation.[13] Willett argues persuasively that the explosion of officially held monetary reserves altered the perception of monetary authorities, the willingness to adjust, and even ratcheted up the minimum levels of reserves which governments sought to hold.[14] This part of the study, the most technical and arcane for the general reader, deals extensively with an interpretation of events and statistics of that period.

Willett next reviews the liquidity implications of the 1973

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9. Willett, *supra* note 1, at 13.

10. On the establishment of the postwar international monetary system, *see* T. Willett, Floating Exchange Rates and International Monetary Reform (1977) and the references cited therein.

11. *See, e.g.,* J. Murphy, The International Monetary System (1979).

12. Willett attributes this breakdown to the inability of the system to adjust to the increase in supply-determined international liquidity caused by the increased size of the United States payments deficit. This was the result of the efforts by the United States to finance the Vietnam War without an increase in taxes thereby overburdening the United States economy. Willett, *supra* note 1, at 28.

13. *Id.* at 29-50.

14. For a further discussion of the policy reactions by the major industrial countries to this monetary expansion *see* L. Laney & T. Willett, *The International Liquidity Explosion and Worldwide Monetary Expansion: 1970-1972,* Claremont Working Papers (Claremont Graduate School, (1980)).

oil shock and succeeding events through the 1970's.[15] The accumulations of reserves by the oil exporting countries were substantial, but not so large as some of the early forecasts.[16] Nevertheless, he concludes that the ability of the international financial system to accommodate the shock was probably greater under floating rates than it would have been under the Bretton Woods fixed exchange system. Similarly, for many of the same reasons, Willett feels that the large dollar holdings abroad currently should not be viewed in isolation as threats to the soundness of the dollar.

His analysis emphasizes the need to look beyond the behavior of reserve aggregates in order to determine the effects of liquidity expansion. Reserve aggregates held by governments and their rates of growth are not, taken alone, appropriate measures of the effectiveness of the system. Thus the problem of international supervision of the adjustment process must be confronted directly, not just as a reaction to the size of the reserve aggregates.

The third section of the study develops this theme and offers some specific proposals for policy making.[17] Willett argues that various bureaucratic, political and economic incentives make the current international monetary arrangements considerably more stable than many critics have argued. It must be noted in passing that Willett was Deputy Assistant Secretary of the Treasury in the early 1970's and thus is associated with (and perhaps inclined to defend) the changes he describes. He refers to various models for organizing the international monetary system, including the "free for all regime," the automaticity of the gold standard, supranationality with the IMF as a truly international central bank, hegemony with one country (such as the United States) in control, and multilateral negotiation.[18] He suggests that the most practical solution would be a combination of judgmental international guidelines coupled with a great deal of passivity on the part of the United States.[19] This would argue for a large element of "benign neglect"

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15. Willett, *supra* note 1, at 50-76.

16. *See* T. Willett, *The Oil Transfer Problem and International Economic Stability*, Princeton Essays in International Finance, No. 113 (1975).

17. Willett, *supra* note 1, at 76-101.

18. *Id.* at 81-82. These models are from B. Cohen, Organizing the World's Money: The Political Economy of International Monetary Relations (1977).

19. For an elaboration on this solution *see* T. Willett, Floating Exchange Rates and International Monetary Reform (1977).

toward the United States balance of payments, a position held by many associated with the freeing of exchange rates in the 1970's.

Willett rounds out this section with a reasoned argument that current deviations from a desired economic optimality are not sufficient to trigger major international monetary reform. Instead, he argues persuasively for marginal improvements in the existing system. Such improvements would include allowing the expansion of the special drawing rights (SDR), tying the expansion of SDRs to a greater ability of the IMF to monitor official dealings in exchange and money markets, and allowing for substitution facilities at the IMF so that countries accumulating less desirable currencies may, under certain conditions, exchange them for SDRs or more useful reserve currencies.[20]

In a brief final summary chapter, Willett offers some policy-oriented conclusions.[21] The first three deal with the incentives facing national decision makers, the inadequacy of reserve aggregates as a guide to liquidity policies, and the importance of continuing flexible exchange rates combined with surveillance of official borrowing from private financial markets. Willett's fourth conclusion is that the explosion of liquidity had some effect on worldwide inflation, but much less than that attributed to it.

His last four points focus on the technical functioning of the international monetary system and the IMF, recognizing the fact that countries will not easily sacrifice national sovereignty. Willett argues that the expansion of the Euro-currency markets and official borrowing from private institutions have not caused global inflation or loss of financial discipline. Major international capital flows reflect the fundamental conditions of particular countries, and are thus not in themselves bad; they are only the "bearers of bad tidings." Finally, the IMF needs resources for discretionary lending in cases in which substantial official exchange market intervention is desirable. At bottom, however, stable national economic and financial policies and continued strengthening of the basic fabric of international economic cooperation are more important sources of international monetary stability than

20. Created by the IMF in 1967, Special Drawing Rights are accounting units, distributed among member-countries of the IMF. They are usable to cover balance-of-payments deficits. D. Snider, Introduction to International Economics 369-70 (5th ed. 1971).

21. Willett, *supra* note 1, at 102-03.

the IMF or other institutional adjustment mechanisms.

This study is a tightly reasoned and worthwhile analysis of significant problems not usually addressed in the pages of the business or legal press. It will be instructive for those with the time and inclination to digest it. The questions addressed are primarily economic, not legal ones. For those interested in the evolution of the managed floating rate exchange system and some of the issues now before the international financial community, the book will be of value.

It should be clear from this brief and necessarily superficial review that *International Liquidity Issues* is not a work for everyone. The intended consumers of Willett's study are presumably government policy makers, negotiators and lawyers. Willett's defense of the exchange rate system and his pleas for modest modifications will provide much grist for their mills. A second audience will be found among economists, academicians, and those other writers whose works are so extensively noted in Willett's footnotes and bibliography. For those audiences, the study contains a great deal, and will aid in their search for a more stable international monetary system.