

GUIDELINES FOR INTERNATIONAL MONETARY REFORM

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THE INTERNATIONAL MONETARY SYSTEM AND INTERNATIONAL LIQUIDITY

Address by the Managing Director of the International Monetary Fund, Mr. Pierre-Paul Schweitzer, at the Institut d'Etudes Bancaires et Financières, Paris, June 2, 1965

The subject on which you have asked me to speak today—"The International Monetary System and International Liquidity"—is one that has increasingly occupied the minds of economists and international financial authorities in the recent past. There have been many studies and plans, many statements of national objectives, and vigorous exchanges of views. We are now approaching the time, I hope, when it will be possible to attempt a further step—to arrive at a fairly clear international consensus of the directions in which we ought to move in this important field. I therefore welcome the opportunity to speak to you on this subject.

Our plans for the future must, I believe, be based on our answers to three basic questions: First, what is the nature of the international monetary system, and what do we want to accomplish through it? Second, to what extent has the present system succeeded, and to what extent has it failed, to accomplish these ends? Finally, what are some of the ways in which the international monetary system can be improved? My remarks will deal with these three questions.

The international monetary system, in its widest sense, includes the broad network of banking and commercial practices through which day-to-day international transactions are undertaken. The pricing of international shipments, the extension of credit, and the settlement of accounts take place in terms of many currencies. Mainly, these are the currencies of Western Europe and the United States, and more particularly, within that group, the major "trading currencies": the U.S. dollar and the pound sterling.

The predominance of the currencies of major trading countries is not surprising. A country with a very large world trade will develop a network of banking arrangements necessary for conducting that trade. The facilities and experience offered by these arrangements are then available, not only to transact the trade and related payments between that country and its trading partners but also those between other countries. The fact that a large trading country is also likely to have a well-established money market, and to be an important source of capital, further extends the use of its currency. For these and other reasons, such a country is likely to have long-established relationships with many other countries, causing them to look to it as the center of their own international financial arrangements. In a basic sense, therefore, the international monetary system tends to be founded on

the currencies of a cluster of countries which loom large in the total trade of the world. I shall return to this point later, when discussing the reserve currency system.

SCOPE OF THE PRESENT SYSTEM

In terms of the discussion which concerns us tonight, however, what is meant by the international monetary system is the complex of international rules and understandings which have been created largely on the basis of these traditional mechanisms and practices, in an effort to ensure, by international agreement, a fair and efficient method of conducting international financial transactions.

It includes, for example, the par value system which is embodied in the Articles of Agreement of the International Monetary Fund (IMF), under which a country maintains a fixed value of its currency relative to gold and to other currencies, with alteration of the value being reserved to circumstances of fundamental disequilibrium and generally requiring the prior consent of the Fund. It comprises also those provisions of the Articles of Agreement of the Fund and of the General Agreement on Tariffs and Trade (GATT) under which restrictions on trade and on current payments are generally allowable only in situations of balance of payments difficulties and are subjected to international control. It comprises the provisions of the Fund designed to foster the interconvertibility of currencies. In addition, we must bring under the concept of the international monetary system all those *de facto* practical arrangements which give life and reality to the legal provisions. For example, there is the practice whereby most countries, including all the main industrial countries, stabilize their rates of exchange by buying and selling dollars on the exchange market, while a number of other countries achieve the same result by pegging on sterling or on the French franc. There is also a fairly widespread *de facto* liberalization of capital movements by the industrial countries, a liberalization which, I must add, has recently shown signs of being reversed.

Finally—and this is what many people have particularly in mind when they speak of the international monetary system—there are the arrangements under which countries hold their external reserves in the form partly of gold, partly of convertible currencies, such as the dollar, sterling, or the French franc, and partly of claims on the IMF. The function of these reserves, supplemented by the network of bilateral credit arrangements established between many of the national monetary authorities, is to make it possible for countries to finance their balance of payments deficits; and the volume, the distribution, and the manner in which these reserves are made available have obviously an important bearing on that aspect of the international monetary system which is concerned with the adjustment of the disequilibria that have given rise to those deficits.

That, in brief, is what the international monetary system is. I turn now to the question of its function—of what we expect it to do. Sometimes people speak as if the sole desideratum of such a system were to ensure that any disturbances in balance of payments equilibria be eliminated as quickly as possible. This emphasis on adjustment of payments deficits or surpluses is understandable, for adjustment has

frequently been too slow; nevertheless, it is an oversimplified presentation of the problem. It is not enough that international payments should balance. The question is, what sort of balance and at what cost will it be achieved? Practically speaking, what we have to aim at is a balance achieved with the least possible sacrifice of the following generally accepted objectives: first, full employment and a steady rate of growth; second, the avoidance of excessive price increases; third, the maintenance of the maximum degree of freedom in international trade and current transactions generally; and fourth, the avoidance, so far as possible, of distortions in the international flow of capital and financing. Some would add exchange stability as a fifth objective in its own right, and its promotion is one of the purposes of the Fund. It is also a means to the attainment of the other objectives.

When disequilibria occur in international payments, they give rise to international reserve movements and other forms of official financing. Such financing, when it is excessive in amount or in duration, will itself constitute a distortion in the flow of real resources, and that should be avoided. However, deficits and surpluses should not be eliminated too abruptly and at too great a cost in terms of the other objectives I have mentioned.

COMPARISON WITH THE GOLD STANDARD

Some who stress the importance of prompt correction of payments imbalances cite the mechanism of the gold standard. If there could in these times be such a standard, working as smoothly as its theoretical formulation suggests, it would indeed be a quick and relatively automatic regulator of imbalances. The supply of money in each country would be geared more or less closely to the inflow and outflow of gold. Countries with a tendency to payments deficit would find their money supply and their prices falling and their competitiveness increasing, while countries with a tendency to surplus would experience precisely the opposite effects. Under these conditions, disequilibria would not last long, and the needed amount of official financing in the form of reserve movements would be very limited.

I should like to make two related observations on this picture of the operation of the gold standard. Before World War I, when sterling was the great world currency, the sensitivity of sterling to gold movements and to changes in interest rates provided an adjustment mechanism which, for part of the world at least, performed the classical functions of the gold standard. But even those who place great emphasis on gold recognize that the system which operated before 1914 entailed difficult and harsh internal adjustment processes. It is therefore important to keep in mind—when considering such mechanical regulating devices—that when the gold standard was in operation, its successes in terms of external balance were attained at the expense of the other objectives I have mentioned.

My second observation is that in the world of today national authorities must be expected to place a higher priority on the management of the internal economy than was done in earlier times. Public understanding that unemployment and economic stagnation can be overcome by public policy, and that they need not be suffered as conditions beyond the control of man, is one of the most potent forces of the

modern world. It is derived from, and it has stimulated, the development of techniques for managing the internal monetary situation and, beyond it, the national economy. The result has been that high employment and growth rates have been established as firm and attainable social goals in every country, and every government seeks to equip itself with the tools of monetary and economic management which will allow it to attain those goals. Countries reject the concept, implied in the gold standard, that deflation and economic stagnation, or inflation and overheating of the economy, must be accepted in the interests of external equilibrium; and in very many countries, the most pressing task of national financial authorities is to accommodate the public's demands for high employment, economic growth, and price stability, and to do so while maintaining internal and external balance. Within any context of monetary and economic management, circumstances will often arise in which countries will be faced with difficult choices among several external and internal policy objectives. Deficit countries may have to choose degrees of deflation and stagnation in their economic life, or adjustment in their exchange rates, or the adoption of restrictions of one kind or another on imports and on the outflow of capital. Surplus countries may be forced to choose between inflationary pressure, or revaluation of their exchange rates, or the adoption of steps to restrict the inflow and to promote an outflow of capital.

ACHIEVEMENTS OF PRESENT SYSTEM

The international monetary system of today is thus a complex instrument, with the equally complex objective of attaining simultaneously, for each of a very large number of countries, an appropriate balance among a number of internal and external objectives. How well has the system served to attain this balance? That is the second question I should like to consider.

A broad distinction must be made, in this respect, between the developing countries and the industrial countries. Within each group there have been varying degrees of success. By and large, however, the developing countries have found it difficult to achieve simultaneously the goals of rapid growth and internal and external stability. Restriction on imports, on payments for invisibles and on capital movements have often been resorted to; exchange rates have depreciated; and internal imbalances have interfered with the expansion of the economy. This has happily not been the universal picture of the past 15 or 20 years, but it has been a common one. It is gratifying to note, however, that in recent years there has been a growing awareness of the contribution which stability can make to sustained growth, and many developing countries are showing a determination to stabilize their internal and external economies to provide a basis for economic development.

With respect to the industrial countries, on the other hand, the system has, until recent years, worked with a very high degree of success, with much of the credit going to national governments which have been remarkably successful in pursuing policies of full employment, to the United States for the generous aid which it furnished toward the reconstruction of the European economy, and to the cooperative actions of the industrial countries within the framework of

the Organization for European Economic Cooperation (OEEC), the Organization for Economic Cooperation and Development (OECD), and the European Economic Community (EEC). Between 1950 and 1964, production in the industrial countries expanded at a rate of more than 5 percent per annum and the labor force by 1.5 percent per annum; since 1950 the large pockets of structural unemployment which at one time existed in most European countries, and which seemed likely to persist, have been largely absorbed.

At the same time, comparable and related progress has been made by the industrial countries in the removal of barriers to trade and in shifting from bilateral to multilateral payments. It is true that inflationary pressures have been felt, and that the cost of living in industrial countries has increased over the same period by 3 percent per annum. This, however, has been due much less to any deficiencies in the international monetary system than to the inherent difficulty involved in reconciling full employment with price stability, a difficulty which is evoking attempts at establishing what in recent years have come to be known as nationally agreed "incomes policies."

These impressive results have been achieved with rather slight use in the industrial countries of the instruments of balance of payments adjustment that were provided for at Bretton Woods. With the exception of one large-scale and widespread devaluation in 1949, which could be considered a part of the postwar readjustment process, there has been relatively little change in agreed par values. Among the more industrialized countries of the OECD, changes have been limited to individual devaluations by France and Canada, and one small revaluation of the deutsche mark and the guilder. Similarly, the instrument of quantitative restriction on imports, which was provided for in the GATT as a permanently recurrent, though temporary, facility for meeting balance of payments difficulties, has in fact been practically abandoned by countries once they have succeeded in dismantling controls. Indeed, attempts at achieving a substitute for balance of payments restrictions on imports in the form of temporary import surcharges have not been too well received. Finally, restrictions on capital payments, which were not placed under the same requirements of Fund approval as restrictions on current payments, have been subject to a widespread and substantial dismantling, although this tendency to liberalization in the capital field has recently been faltering and retrogressing.

On the other hand, the industrial countries have applied the instrument of monetary policy or, more generally, internal financial policy, for balance of payments purposes to a much greater extent than might have been anticipated at the time of the Bretton Woods Conference. This has been attributable in part to certain favorable features in the general economic environment; namely, the fact that, in a general environment of high demand and expanding output, countries have found that they could correct their incipient balance of payments deficits rather easily by merely bringing about a temporary pause in the process of expansion. Also, the industrial countries of continental Europe, which started after World War II with little or nothing in the way of reserves, have experienced the fastest growth in productivity and competitiveness and have gained reserves, largely from the United States. The latter country, on the other hand, until recent years experienced no

real tension in its balance of payments, first because its reserves at the end of the war were very large, and second because other countries, as they accumulated reserves, were willing to hold a substantial portion of the increase in dollars.

There has thus been a mixture in the degree of success which countries have had in reaching the objectives that the international monetary system seeks to promote. The combination of growth and internal and external stability has for many countries not been easy to achieve, and this has in large measure reflected urgent programs for raising low standards of living. Largely because of a more fortunate economic and financial position, the efforts of the industrial countries to achieve a balanced internal growth without external distortions have, on the other hand, been very successful. Even for these countries, however, weaknesses in the system have manifested themselves in the last few years and have given rise to proposals for reform.

WEAKNESSES IN PRESENT SYSTEM

It is convenient to begin a review of these weaknesses with capital movements. The Articles of Agreement of the Fund leave control over capital movements almost entirely to the discretion of national governments. Later on, a view that had been dominant before 1930 began to gain ground: the view that freedom of capital movements was highly desirable in itself, and that the movement of short-term funds might be regarded as an equilibrating factor in international payments which would diminish the need for reserves. In fact, the period since the late 1950's, especially after main European currencies became convertible, has been characterized by a massive revival of capital movements among the industrial countries, in particular—but not only—from the United States to Europe. The so-called Euro-dollar market has become a large pool of short-term funds connecting the money markets of many countries and influencing them all. Long-term capital markets have also become more closely linked through direct investment, through dollar loans issued in European markets, and through other channels. These new developments represent a remarkable step in the direction of the financial integration of the industrial economies, and it is not surprising that these sudden and very large changes have brought about a swing in the other direction in the pendulum of opinion, toward emphasizing that the mobility of international short-term funds inevitably hampers countries in the use of monetary or credit policy for domestic purposes. The massive movement of long-term as well as short-term funds from the United States to European countries has caused persistent balance of payments problems for the former, while accentuating the difficulties which the latter have experienced in containing domestic inflationary pressures. Another aspect now emphasized is that mobile funds play a disequilibrating at least as often as an equilibrating role, especially if there appears to be any prospect of exchange appreciation or depreciation on the horizon.

As a reaction to these developments, we have witnessed a tendency on the part of several surplus countries to limit the inflow of foreign funds, and on the part of deficit countries to discourage their outflow by fiscal measures, such as the interest equalization tax and by more direct formal and informal measures. The right way of dealing with

capital movements indeed presents some very difficult problems. It is difficult to judge to what extent they are a response to speculative or other temporary factors, to what extent a response to considerations of fiscal evasion, and to what extent a persistent and fundamentally sound tendency for capital to seek the highest real return—a tendency to which other elements in the balance of payments should in fact adjust.

The unexpected magnitude of capital movements in recent years thus presents a new area of problems which confront the international monetary system. Should these capital flows be considered as mere temporary phenomena and be financed by movements in reserves? Should it be expected that trade balances will be radically changed to accommodate them? Or should they be limited in some way by controls?

One thing does, however, seem clear, and it has been emphasized by the reaction of some countries to the recent U.S. interest equalization tax and other measures related to capital movements: the continued substantial dependence of the world in general on the U.S. money market has allowed an element of imbalance to persist in the system. The United States was, immediately after the war, the preponderant source of many physical goods, international aid, and investment capital. With recovery and prosperity, the European countries have been able to make increasing contributions to the world's exports and to international aid programs. They have now, I think, to make all feasible progress in becoming net exporters of capital.

Another element which adds to the difficulties of managing the international monetary system today is that changes in price levels cannot be counted upon as a quick or reliable equilibrating force between deficit and surplus countries. I have noted earlier the social forces which are arrayed against deflation. Modern conditions make it very difficult for deficit countries to do more than keep their price levels constant without giving rise to substantial underemployment of labor and plant. The fairly stable level of prices maintained in the United States in the past few years has, in fact, prevented difficult problems from becoming much more difficult. On the other hand, there is an equally understandable feeling in surplus countries that any addition, through their payments surpluses, to inflationary pressures already present in their economies should be resisted. Thus, whether or not price adjustments played a large equilibrating role in the past, it is clear that there are limits to what can be expected in this direction in the deficit countries, and there will be strong resistance in the surplus countries to achieving balance through price movements. This would be particularly true if imbalances were large and there were a need for fairly rapid equilibrating movements.

RESERVES AND INTERNATIONAL LIQUIDITY

The dissatisfaction with the operation of the international monetary system which has captured most of the limelight in recent years has been addressed mainly to the arrangements under which the world is provided with international liquidity and reserves, and in particular the practice sometimes referred to as the gold exchange standard, under which countries may—and very generally do—hold one or two foreign currencies in their reserves along with gold. Recent attacks

have been made on this system largely because of the manner in which it creates liquidity. Before discussing the advantages and disadvantages of this system, therefore, I must say some introductory words about liquidity generally.

A country's external or international liquidity, which may take the form of reserves or credit facilities, represents all those resources to which it has ready access for the purpose of financing its balance of payments deficits. If there is too much international liquidity in the world—and particularly if there is too much in the possession of countries that are likely to incur deficits—financial authorities are likely to worry too little about possible deficits. They may pursue overexpansive financial policies and generate excessive inflationary pressure, and countries with a tendency to a balance of payments surplus may find themselves providing real resources to deficit countries on an excessive scale because balance of payments financing is too easy and cheap. If there is too little international liquidity in the world, deficit countries will have too little time to adjust themselves in a desirable way to the disequilibria which develop, and will be forced to impose restrictions on trade and capital movements, as well as unduly restrictive financial policies. As a result, the growth in world production may be hampered and the prices of primary products depressed.

To what extent these various consequences will ensue depends in part on the composition, as well as on the quantity and the distribution, of the international liquidity which is available. We in the Fund find it useful to distinguish between unconditional liquidity, which is freely available to a country in the form of reserves, and conditional liquidity, whose availability is subject to the adoption of appropriate policies designed to achieve or maintain payments balance. Countries hold significant amounts of unconditional liquidity in the form of Fund gold tranches, and the Fund is much the largest provider of conditional liquidity in the form of drawing rights under the credit tranches. We consider it to be in the interest of all countries that this latter type of liquidity should be available in substantial supply, so as to permit countries facing deficits to have sufficient time to make necessary adjustments, while maintaining economic activity at a high level and keeping international trade and payments as free as possible from restrictions. This means that the quotas of the Fund should be adequate to meet justifiable demands for temporary assistance.

GOLD EXCHANGE STANDARD

I turn now to the question of the ways in which countries acquire unconditional reserves and, in particular, the practice known as the gold exchange standard, under which countries, according to their own desires, hold in their reserves varying amounts of foreign currencies which are directly or indirectly convertible into gold. At the outset of my remarks tonight, I mentioned that most international payments are conducted in the currencies of the great trading nations. It is not surprising that, often without conscious planning, there should have been an evolution from maintaining working balances in such currencies to holding reserves in them. The holding of currency rather than gold is both economical and convenient, since market operations can be conducted only in a currency moving in the stream of

international banking and trade transactions. For these reasons, balances were often built up in what have come to be known as reserve currencies. To the extent that deficits of the great trading countries are settled by increases in foreign holdings of their currencies, new liquidity is created.

It is becoming more and more widely recognized that this practice is becoming inadequate as a method of ensuring an adequate growth in world reserves, and this recognition legitimately lies at the heart of the continuing search for ways to strengthen the international monetary system. At the same time, however, I must say that some of the arguments advanced in criticism of the gold exchange standard seem to me of doubtful relevance. For example, it is argued that the system provides an unfair advantage to one or two reserve-center countries in that it permits them to finance their balance of payments deficits painlessly and automatically. There is some truth in this argument, but it has been overstated. The real point is rather that, as long as a reserve-center country is strong and enjoys unquestioned confidence, it can finance a proportion—though seldom the totality—of its balance of payments deficit in the form of an accumulation of liabilities to foreign monetary holders; but that as soon as this process has come to a point at which confidence is weakened, the pressures on the reserve-center country will become at least as strong as, if not stronger than, the pressures on the nonreserve countries.

We now come to what I do think is a valid point of objection to any system which would rely to a very large extent on changes in holdings of reserve currencies to achieve the adjustment of external imbalances. The supply of reserves created in this way would depend on the somewhat accidental circumstance of whether the reserve-center countries happened to be running deficits or surpluses, and also on whether there did or did not happen to be full confidence in the future value of their currencies. Thus, while I see an important role to be played by reserve currencies, this does not mean that they should continue to be relied upon as a major source of reserves for future needs. All prognostication in this field is extremely hazardous, but I see no reason to depart from the view, expressed in the last annual report of the Fund, that over the next decade or so it seems unlikely that the growth in reserves from gold production and from the accumulation of reserve currencies will suffice to meet the growing need for reserves that may be expected to occur as international transactions continue to increase.

There is wide agreement that there is no urgent need for additional international liquidity. However, the situation would alter if the measures recently taken to strengthen the balance of payments of the United Kingdom, and even more importantly that of the United States, are successful; this development would eliminate an important source from which liquidity has been provided in the recent past. Moreover, in dealing with matters such as this, which are vitally important to millions of people, it is always prudent to have agreed on a course of action well before the need for action itself arises. It is not too early to search for the best ways to meet demands for additional liquidity, as and when they may arise in the future. I turn, therefore, to this aspect of the question of how the international monetary system can be improved.

IMPROVING THE PRESENT SYSTEM

It would be well, first, to consider the point that the present mechanisms by which reserves are created are in large part arbitrary. They have no particular tendency so to adjust the volume of reserves as to promote the most satisfactory development of the world economy. This does not mean, in my opinion, that one should seek to replace the practice of holding reserve assets in the form of currency by some new and agreed mechanism for creating world fiduciary reserves on a multilateral basis. I do indeed believe that there is need to continue developing multilateral facilities. But our aim should be to supplement and not to supplant the existing system. This process will be greatly facilitated if the payments positions of the United States and the United Kingdom are corrected. It may then be expected that aggregate official holdings of sterling and dollars will be a relatively stable element in world reserves. Under those conditions, the evolving mechanism can continue to be based on the free choice by monetary authorities in their decisions whether or to what extent they are going to hold gold or foreign exchange and the kind of foreign exchange they are going to hold; this free choice expresses genuine differences in countries' circumstances and needs. At the same time, the evolving fiduciary instrument (and the Fund itself already provides one such instrument) created by multilateral agreement can be developed alongside of and in harmony with familiar reserve assets, such as gold and national currencies.

In a situation in which holdings of dollars and sterling were reasonably stable, I would venture to guess that there would be no point in pressing forward in response to proposals that have sometimes been made that existing dollar and sterling balances be transferred wholesale to the Fund in exchange for gold-guaranteed claims on that institution. Of course, any drawing on the Fund by a reserve center results, directly or indirectly, in an increase of countries' claims on the Fund and a reduction in their claims on the reserve centers. The recent massive transaction of the Fund with the United Kingdom is a case in point and it shows that, within the framework of the Fund's present operations, it is feasible to relieve pressure on the reserve centers and reduce outstanding balances in reserve currencies when and insofar as that is appropriate.

It has been suggested by some economists that countries, or at least the main industrial countries, should cease to hold foreign currencies in their reserves. As they recognize, this would involve a substantial depletion of international liquidity—indeed, a very substantial depletion if most official dollar and sterling holders were to cease holding those currencies. Their proposal therefore is to counteract this by a large once-for-all increase in the price of gold in terms of all the principal currencies. Sometimes a doubling in the price of gold is suggested. A chance of this magnitude, though it would involve great inequities, would probably give a substantial stimulus to the production of gold and result, for a time, in a proportionate rate of growth of reserves (which would then consist entirely of gold) greater than that which has been experienced over the last decade or so in monetary gold stocks. However, nothing in the system of reserve creation would be fundamentally improved. Reserves might rise faster; they might even rise too fast for a time; or they might still not rise fast enough to meet the

need for them. There is no means of telling. For example, there might be an initial dishoarding of substantial sums of gold, which would swell official reserves. But how long, or how extensive, this dishoarding would prove to be can only be conjectured. Sooner or later, the increase in the price of gold would undoubtedly provide a powerful stimulus to the practice of private hoarding in the hopes of a further increase. Indeed, this would not be unreasonable; for if the only instrument available to control the level and growth of reserves is a change in the price of gold, it is natural to assume that this instrument would, from time to time, be used. It is not evident that monetary discipline would be enhanced by a system which could so readily write up the reserve base. I cannot believe that a system which would give such strong encouragement to speculative factors is the best that we can devise by way of rational control over the volume of international liquidity.

There has been much debate about how the means available to the international monetary system to expand liquidity can best be evolved. Broadly speaking, two main alternatives attract most attention. One is that some new institution or arrangement should be set up, confined for example to the main industrial countries or in any event to a limited group. The other approach proceeds by way of developing the functions of an existing institution of worldwide scope; namely, the International Monetary Fund. I should like to outline for you some of the reasons why I lean toward the second alternative.

THE FUND AND INTERNATIONAL LIQUIDITY

In the first place, the Fund is already equipped to finance the temporary balance of payments deficits of its members, including those of the industrial countries, by a mixture of conditional and unconditional liquidity. Its activities in this field extend to the earliest days of its operations, and its assistance has been of considerable magnitude. Indeed, since 1947, more than \$7 billion has been made available to industrial countries in the form of drawings. Assistance was given to the United States in recent years in the form of the repayment of dollars drawn from the Fund in earlier years; and the drawing by Italy in 1964 took the form of mobilizing the virtually unconditional liquidity which had been created by earlier drawings of lire. The recent drawings by the United Kingdom have demonstrated the ability to mobilize additional sums of conditional liquidity, against which the creditor countries acquired reserve assets in the form of reserve positions in the Fund plus \$650 million of gold. All these activities to assist individual industrial countries have been important in themselves; but what seems to me to be more important is the evidence they bear that the Fund is ideally situated to perform the complementary role of evolving new forms of liquidity. It has already, in fact, done so in the instances I have cited.

A second advantage of operating through the Fund lies in the variety and flexibility of the methods of creating reserve assets that are open to it. For example, there can be in the Fund a further development of a variety of liquidity-creating facilities—some automatic, some conditional, some bearing interest and some not, some open to all members and some possibly limited to members able to meet certain tests or to make certain contributions.

I turn now to some even more important considerations. It seems to me highly desirable, from the standpoint of the maintenance of good relations and a spirit of cooperation between countries at all stages of development, that the richer nations of the world should not appear to be clubbing together to create reserves—out of nothing as it were—for themselves alone. By entrusting this function to the Fund, all countries, in proportion to their roles in the world, can be given their due share in the control over the creation of reserves and a due participation in the benefits of such creation. The needs of all the prospective countries—developing countries as well as industrial countries—can more readily be dealt with in a forum that is worldwide. But the vital interests of prospective creditors are also protected, as they must be in any financial institution. Creditor countries share importantly in the decisions of the Fund, including of course its decisions on the use of its resources. It need not be feared that countries urgently needing resources for development, or for other purposes, would run away with the process of reserve creation or that creditor countries would be faced with burdens they were not willing to assume. The Fund has amply demonstrated that it can administer a worldwide pool of resources guided by policies which assure that the resources will be properly used.

I would not like, toward the end of a rather long speech to deal extensively with details about the precise methods whereby the Fund could create reserves—and, as a matter of fact, these details are not in themselves very important from a broad point of view. In principle, these methods are analogous to those which a domestic banking system can use to expand liquidity within a country. First, banks can provide assured borrowing facilities which constitute liquidity in the hands of the holder; second, they can acquire assets, be it in the form of loans or investments, thus putting money into the economy in the form of new deposits.

The methods of reserve creation that might be applied by the Fund—or indeed any other institution set up for the purpose—would be essentially similar. I have already mentioned that countries now have virtually automatic drawing facilities in the so-called gold tranche, which corresponds to the resources in gold that they have made available to the Fund plus the net disbursement of their currencies by the Fund. To create additional liquidity, the Fund could allow countries to draw with the same degree of freedom some amount of the quota beyond the gold tranche; or the Fund could expand the reserve positions of countries in the Fund by acquiring certain special assets, of a type which it does not hold at present; and to finance these assets, it could issue loan claims to countries that would be prepared to add to their reserves in this form.

The new reserves which the Fund could thus create could be given features that would make them qualify as reserve assets of central banks, together with gold and the major reserve currencies. These claims could have a gold guarantee, and they could, in whole or in part, bear interest. They would be liquid claims that could be used on demand in case of need. In many respects, they could be similar to the claims on the Fund that eight industrial countries now already hold under the General Arrangements To Borrow, so that they would constitute a reserve asset already familiar to the monetary authorities in leading countries.

So much for the possible characteristics of new reserve assets, i.e., the new liabilities of the Fund. There are many ways in which the matching new assets of the Fund could be arranged. They might be arranged in the same countries that were acquiring the new Fund liabilities by a simple exchange of claims between the Fund and some or all of its members—in amounts that might be in proportion to quota or on some other principle. They might also take the form of purchases by the Fund of the liabilities of institutions, such as the International Bank for Reconstruction and Development, which would, in turn, invest the resources so obtained in member countries.

There are technical differences among these various techniques, but in the end they are not of overwhelming importance and the primary issues to be decided are essentially these: (1) How can an equitable distribution be achieved of the additional purchasing power that is created by any international action to increase liquidity; and (2) how can the decisions on these questions be made in a manner that adequately takes account of the varying interest of countries?

I have discussed with you, rather frankly, a number of ideas, some of which only a few years ago would have been considered exceedingly unorthodox. I have done so partly because I think that the international monetary system, as it exists today, is sufficiently strong, so that we can afford to consider in a calm and dispassionate manner the possibilities of amending and improving it. I have done so also, as I indicated at the beginning of this statement, because I think it important to work toward a clearer international consensus of the directions for future action.

(NOTE.—This is a translation of the address that Mr. Schweitzer delivered in French.)

INTERNATIONAL LIQUIDITY*

(By Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs)

Fifteen days ago, the Prime Minister of Great Britain, Mr. Harold Wilson, devoted a section of his major public speech in New York to consideration of international liquidity. He took the view that the world should push forward promptly in comprehensive planning to avoid a liquidity squeeze which might result from the disappearance of the U.S. balance of payments deficit.

Some weeks ago, President de Gaulle suggested that the world should return to a gold standard system, and Mr. Jacques Rueff, a well-known French economist, has recently proposed the same course of action, with the additional suggestion that the price of gold be doubled in order that reversion to a gold standard system might take place without drastic deflationary consequences for the world economy.

The President of the German Bundesbank, Karl Blessing, recently endorsed the present international monetary system but suggested the possible desirability of standardizing the composition of national reserves by agreeing on an appropriate ratio between holdings of gold and reserve currencies.

Former Secretary of the Treasury Douglas Dillon in his last press conference suggested that one of the major questions with which his successor would have to wrestle would be that of the future adequacy of world liquidity. Secretary Fowler has agreed "that the greatest challenge in this area is to work out a steadily improving international monetary system so as to facilitate a continuing expansion of trade and economic development in the free world."

The U.S. position with respect to the liquidity issue has been made very clear by President Johnson, who said in his message to Congress on the balance of payments:

The measures I have proposed in this message will hasten our progress toward international balance without damage to our security abroad or our prosperity at home. But our international monetary responsibilities will not end with our deficit. Healthy growth of the free world economy requires orderly but continuing expansion of the world's monetary reserves.

During the past decade, our deficits have helped meet that need. The flow of deficit dollars into foreign central banks has made up about half of the increase in free world reserves. As we eliminate that flow, a shortage of reserves could emerge. We need to continue our work on the development of supplementary sources of reserves to head off that threat.

We must press forward with our studies and beyond, to action—evolving arrangements which will continue to meet the needs of a fast-growing world economy. Unless we make timely progress, international monetary difficulties will exercise a stubborn and increasingly frustrating drag on our policies for prosperity and progress at home and throughout the world.

*An address at the Ohio State University in connection with "Distinguished Lecturers in Monetary Policy," jointly sponsored by the university and the Ohio Bankers Association, Columbus, Ohio, Apr. 29, 1965.

Today I would like to discuss with you just what it is that all of these distinguished people are talking about and why there is this general and widespread interest in international liquidity.

We might start with a very simple statement as to the purpose of international reserves. Their primary purpose is to permit a country to ride through any balance of payments deficit while making an orderly adjustment of its international and domestic policies to restore balance of payments equilibrium. In this, the purpose of international reserves is very similar to the purpose of individuals and businesses in setting aside and holding liquid assets for an emergency. A complication with which I shall not deal today is that international reserves in many countries play an additional role as partial determinants of the domestic money supply.

International reserves, of course, are not held in the same form as the reserves of a private business. The traditional reserves of nations are gold and reserve currencies. A reserve currency, if you will excuse the tautology, is a currency which, by general agreement, nations are prepared to hold in their reserves. The dollar is today the major reserve currency. The pound sterling is held rather widely, particularly by sterling area countries, and the French franc is regarded as a reserve currency in some parts of Africa. Each nation makes its own decision as to what it will regard as a reserve currency. It bases its decision on the extent to which that currency can be widely used in international transactions, the confidence it has in the stability of that currency in terms of gold and in terms of goods, and the ease with which it may invest and disinvest both its working balances and additional holdings of the currency in question.

The status of the dollar as a reserve currency developed over the years, particularly since the Second World War, from the voluntary decision of many countries that this was the currency which best met their needs as a reserve asset. The reserve currency status of the dollar is greatly buttressed by the fact that the United States is the only country which stands ready to deliver gold at the fixed price of \$35 an ounce to foreign monetary authorities upon request.

But international liquidity has broader dimensions than gold and reserve currencies. When representatives of the Group of Ten—leading industrial countries—began a couple of years ago to study what has come to be called the “liquidity problem,” they placed emphasis upon a broad liquidity spectrum which shaded from owned reserves through certain credit availabilities.

It was agreed that the first additional asset to be included in the broader liquidity concept should be the “gold tranche” position of member countries in the International Monetary Fund. The International Monetary Fund has 102 member countries, and each of these has a quota for which it has paid one-quarter in gold and three-quarters in its own national currency. As a result, one-quarter of its quota in the Fund is referred to as its “gold tranche” rights. Any member country is entitled to borrow from the Fund, virtually without question, any currency it may need up to the amount of its gold tranche position. There is general agreement, accordingly, that the aggregate of gold tranche positions in the Fund, amounting to approximately \$4 billion, should appropriately be considered an element in international liquidity. I might mention, parenthetically, that such gold

tranche positions will be increased to \$5 billion when the 25 percent increase in Fund quotas now underway has been completed.

There are other forms of international credit about as liquid as gold tranche positions in the Fund. In the last four or five years, a network of short-term credit facilities has been created among monetary authorities and central banks of the highly industrialized countries. These are generally referred to as "swap" lines. They consist of agreements that the authorities of one country will make its currency available to its swap partners up to agreed amounts, usually for an initial period of 90 days. If, for example, Italy should find itself in need of dollar currency, it could deposit lire to the account of the Federal Reserve System and the Federal Reserve System would deposit an equivalent sum in dollars to the credit of the Italian authorities. These agreements represent a highly liquid asset for the countries concerned. Swap lines can be activated on only a few hours' notice, and many of them have been so activated throughout the network in many directions in recent years. The total of swap agreements at the present time throughout the network amounts to more than \$2½ billion.

Another substantial element in international liquidity is represented by special Government bonds which the United States has issued to certain of its creditors in recent years to help finance the U.S. balance of payments deficit. These may be denominated in the currency of the holder and are convertible at short notice by the holders into cash. Foreign currency bonds now outstanding amount to \$1.1 billion. Foreign monetary authorities holding these bonds regard them either as part of their reserve assets or as an asset similar to reserves.

In considering international liquidity, it is also appropriate to take into account the availability of credit from the International Monetary Fund beyond the gold tranche positions. As I have said, one-quarter of a country's quota represents its gold tranche; the full quota itself represents the drawing rights beyond the gold tranche. These borrowing rights are not so automatic as gold tranche drawing rights and, hence, not so highly liquid. Consequently, they are not generally regarded as *reserves*. However, they are available in accordance with well understood standards and have been widely used for many years. They represent an important element in total international liquidity.

The report of the Deputies of the Group of Ten, released in August of last year, following their study, brought out several interesting points relative to the growth of international liquidity, as the report defined it, during the 10 years from 1954 to 1963. As noted, they dealt with international liquidity as being a spectrum divided into two broad categories: "reserves" and "credit facilities." The dividing line between these two closely related classifications was fixed in this manner. Credit availabilities that had not been utilized were, broadly speaking, treated as "credit facilities," and these might be available to potential deficit countries in the future, subject to individual credit arrangements. Reserve assets represented the claims of creditor countries that had been established by the extensions of credit to others in the past on their part, through the International Monetary Fund or directly, and that could readily be mobilized for their own use in case they, in their turn, needed foreign exchange resources. This latter category included also the gold tranche claims on the Fund acquired by past subscriptions of gold to the IMF.

During the 10-year period, the reserves of all the countries in the free world rose about \$17 billion or nearly a third. Gold accounted for nearly \$6 billion. Foreign exchange, principally in the form of dollars and sterling, rose nearly \$8 billion, and \$3 billion was contributed by increased claims on the Fund and by the use of bilateral credit facilities.

You will note that only about a third of the total addition to reserves, defined broadly to include the reserve assets noted, was provided by gold. At the end of 1963, countries held in their reserves about \$40 billion in gold or about 57 percent of the total reserves of \$70 billion. \$25 billion was held in the form of foreign exchange, one-half in sterling, and one-half in dollars. These foreign exchange holdings were official reserves and take no account of some \$15 billion in liquid assets held by nonofficial private entities, almost entirely as claims in dollars or sterling.

Apart from the global picture, it is useful to pause a moment to look at the regional aspects of this growth in reserves. During the 10-year period, the eight major nonreserve currency countries of the Group of Ten and Switzerland acquired \$18½ billion of reserve assets, or \$1½ billion more than the world as a whole. This group of countries includes the major part of a persistent surplus area in continental Europe, which has had an unexampled prosperity and an unprecedentedly strong balance-of-payments position. Moreover, this group of countries acquired nearly \$11 billion in gold, nearly twice the total of new gold supplies available for monetary use in the world as a whole. They were able to do so through a substantial redistribution of the gold reserves of the United States.

This was the pattern of the 10 years prior to the study undertaken by the Group of Ten in 1964. Against this pattern, the Ministers and Governors concluded that—

For the international monetary system as a whole, supplies of gold and reserve currencies are fully adequate for the present and are likely to be for the immediate future. These reserves are supplemented by a broad range of credit facilities. The continuing growth of world trade and payments is likely to entail a need for larger international liquidity. This need may be met by an expansion of credit facilities and, in the longer run, may possibly call for some new form of reserve asset.

The Ministers and Governors of the Group of Ten then took several decisions looking toward the future of the monetary system. They undertook a thorough study of the measures and instruments best suited for avoiding and correcting large and persistent international imbalances, compatibly with the pursuit of essential internal objectives. They recommended a procedure for "multilateral surveillance" of the ways and means of financing balance of payments disequilibria. Looking further into the future, since there was a possibility that the supply of gold and foreign exchange reserves may prove to be inadequate for the overall reserve needs of the world economy, they authorized a study group to examine various proposals regarding the creation of reserve assets either through the IMF or otherwise. Finally, they agreed that they would support a moderate general increase in quotas of the IMF.

It might be asked why there was so much concern regarding the future of international liquidity when reserves had increased so rapidly in the previous 10 years. The eight members of the Group of

Ten and Switzerland nearly tripled their reserves during the 10-year period, 1954 to 1963. In fact, some of these countries consider that the growth in their reserves has been excessive and has been a contributing factor to inflationary pressures on the European Continent. Thus, they are particularly concerned that the growth in reserves not be excessive in the future, as a result of continuing deficits in the U.S. balance of payments.

At the same time, they join with the United States in recognizing that there may be conditions in the future, given the remarkably vigorous expansion of world trade and investment, when annual supplies of new monetary gold would alone be insufficient to provide an adequate secular growth in reserves. You will recall that new gold supplied only about one-third of the 10-year growth in reserve assets.

The United States also looks forward to a changing situation; it is not in our interest to continue substantial balance of payments deficits, to pay out increasing amounts of dollars to the rest of the world, and then to be faced with financing a substantial part of that deficit in gold because other countries no longer wish to accumulate important amounts of dollars in their reserves. There is certainly no fixed or absolute level or ratio of our short-term dollar liabilities to our gold reserves. But officially held dollar claims of a liquid character are now just about equal to our gold reserves. They have been rising for about 15 years, and rising quite sharply since 1958. It is quite essential that we bring this long series of balance of payments deficits to a halt. In doing so, we will also stop the process of providing gold and dollar reserves to the rest of the world.

When this happens, there may be a question as to how to provide supplementary reserves in some form, to add to gold and the existing holdings of dollars and sterling exchange. It is, in my view, unrealistic to assume that the world can or should attempt to do away with these existing foreign exchange holdings. The gold exchange standard in itself is a useful and meritorious instrument. But, at the same time, we must exercise moderation in its use, and realize that it has been overstrained by the size and persistence of U.S. deficits, and the resulting supply of dollars.

It is no secret that some European countries feel that the long-continued deficit of the United States has been at best made possible and at worst encouraged and stimulated by the ability of the United States to finance a very substantial portion of its deficit during the past 7 years by paying out dollars that have been added to foreign reserves. If the U.S. deficit had been settled entirely in gold, they assert, the United States would have taken earlier and more rigorous steps to bring its payments into equilibrium.

Accordingly, some of these countries are prepared to argue that the international monetary system at the present time is experiencing a surplus of liquidity, not a shortage. This is perhaps the basis for the suggestion of President de Gaulle that the world should return to a gold standard system. A return to a gold standard would imply a sharp curtailment of world reserves and world liquidity and would carry the threat of worldwide deflation. I need not—for this audience—spell out the detailed mechanism by which this would come about. I mentioned Jacques Rueff, who recently expressed his support for a return to the gold standard in public statements in the

United States. Recognizing that this alone would create dangerous deflationary pressures, he couples his proposal with the suggestion that the price of gold be doubled and that the United States then pay off its liquid liabilities to foreign central banks in gold at the new price. That would mean redeeming some \$14.5 billion of dollar reserves of foreign official holders at a rate of \$70 for an ounce of gold rather than the existing \$35 per ounce. The United States would be left at the end of the operation with gold reserves near the present level, according to the new valuation, and would have wiped out its official liabilities to foreign monetary authorities.

Such a proposal is thoroughly unacceptable to the United States. It combines the proposal that the world once again accept automatic regulation of its money supply according to the vagaries of world gold production with the proposal that the implied and stated commitments of the gold exchange standard be repudiated to the advantage of a few and the disadvantage of many. It is easy to see how it might be appealing to the major gold-producing countries, including the Union of South Africa and the U.S.S.R., and to some countries holding a high proportion of their reserves in gold. It would, of course, be discriminatory against countries which have kept a substantial fraction of their reserves in the form of reserve currencies. Our commitment to maintain the fixed parity of \$35 an ounce between gold and dollars is basic to the stability of the world monetary system. President Johnson has reiterated our unchanging determination to maintain this parity.

We share fully, however, the European view that our balance of payments deficit should be promptly corrected. We do not believe that the existence of the present monetary system has weakened our resolve to eliminate our balance of payments deficit. We have, however, insisted that the deficit be eliminated by measures which would have a minimum impact both on the rate of economic growth in our own country and on the continued economic prosperity of the rest of the free world. We have ruled out measures which would have denied our responsibilities in defense of the free world or in the economic development of less developed countries—and we have done so in the interest of free men everywhere. Our deep reluctance to adopt more restrictive monetary or fiscal policies at home has derived from the unshakable conviction that a strong and growing economy in the United States is a prerequisite both to lasting correction of our balance of payments difficulties and to continued prosperity in the Western World.

I shall not digress at any length to review the extent to which our balance of payments position has, in fact, been strengthened in recent years. The splendid record of price stability which we have maintained through 50 months of steady economic growth has established for us a strong competitive position in world trade and our trade balance is highly favorable. We have reduced the balance of payments impact of our military and foreign aid operations without retreating from our commitments in these areas. More recently, measures have been taken to dampen the outflow of capital from the United States by means of the voluntary cooperation of the banking system and the business community. The United States will, however, continue to be an important source of productive capital.

Before I resume commenting briefly on what I think will be the principal issues to be decided as we cooperate in working out arrangements to assure that adequate world liquidity will be maintained when our deficit has been corrected, I should acknowledge that there is a school of thought—and one which appears to be quite strong in academic circles—that believes in solving the liquidity problem not by increasing liquidity but by reducing the need for liquidity. Members of that school are the advocates of floating exchange rates. They hold that fixed exchange rates alone create the need for large reserves. More importantly, perhaps, they feel that fixed exchange rates constitute a restraining influence preventing individual countries from following domestic policies which might be deemed appropriate for domestic aims. If exchange rates were free to move up and down in the market, a balance of payments deficit would be reflected in a cheapening of the country's currency rather than in a loss of reserves. The cheapening of the currency, in turn, the argument runs, would bring about adjustments in the trade pattern—lower imports and higher exports, among other changes—which would restore balance of payments equilibrium. No country would need to hold large reserves and each country could choose its internal monetary and fiscal policies according to its own system of priorities and without regard for balance of payments effects.

I am not going to try to argue the case for or against floating rates. I would admit, as any student of economics will admit, that the theoretical arguments for floating exchange rates can be presented with great precision and appeal. Operation of the system in a world of imperfect knowledge, imperfect governmental and monetary institutions, and conflicting national ambitions and policies would be something else again. I will merely express the opinion, which is shared by an overwhelming majority of commercial and financial interests, that such a system, in practice, would prove extremely disruptive to world trade and financial transactions. The Ministers and Governors of the Group of Ten have ruled out consideration of any such system and the International Monetary Fund has operated for nearly 20 years in defense of a regime of generally fixed exchange rates, with individual exchange rate adjustments regarded as appropriate from time to time, when individual countries have fallen into a position of fundamental disequilibrium.

As we consider possible methods for assuring adequate liquidity in the future, the next question is whether some new *type* of asset should be created or whether liquidity needs can be met by further development and refinement of existing credit mechanisms.

On the credit side, agreement has already been reached, in principle, on a 25-percent increase in International Monetary Fund quotas. I say "in principle" because, while more than 80 percent of the membership favored the increase, each member must now determine for itself, in accordance with its own legislative procedures, whether it will accept its appropriate share of such increase. The U.S. administration is seeking congressional approval for an increase of \$1,035 million in the U.S. quota. The House of Representatives voted favorably on this bill on Tuesday of this week. We are confident that the total of aggregate quotas in the Fund will be increased from about \$16 billion to about \$21 billion when this operation has been completed. That will

provide an appreciable addition for international liquidity in the form of credit facilities.

The most intriguing aspect of the liquidity question, however, doubtless lies in efforts to devise a new type of reserve asset. I mentioned that the Deputies of the Group of Ten, in their report to Ministers, announced that they had established a "Study Group on the Creation of Reserve Assets" to study the problem which its name implies. The Group is meeting periodically. It is expected to present to the Deputies some time this summer a study which will "assemble the elements necessary for evaluation of the various proposals" which have been put forward.

I cannot speak in detail about the work of this Group. But its terms of reference are public information. The Deputies to the Group of Ten spoke of two types of proposals—

One, the introduction, through an agreement among the member countries of the Group, of a new reserve asset which would be created according to appraised overall needs for reserves;

And the other based on the acceptance of gold tranche or similar claims on the (International Monetary) Fund as a form of international asset, the volume of which would, if necessary, be enlarged to meet an agreed need.

Proposals of the first type vary substantially in detail. Essentially, however, these schemes provide that a limited group of countries, by depositing their own currencies or gold, establish a central pool of monetary resources which would provide the backing for a new reserve unit. Members would receive in exchange for their respective subscriptions an equal value of reserve units. These would represent proportionate claims upon the aggregate pool of resources and these claims or units would be transferable among the members in settlement of surpluses or deficits. The reserve unit itself would be held or used much as gold is now held in reserves or used in international settlements. By agreement among the members, it would assume the nature of gold; it would be held as reserves; its value would be fixed in terms of gold; and its acceptance by any member would be automatic according to stipulated conditions.

For example, some proposals would call for creation of a limited amount of reserve units and for the use of these units in fixed proportion with gold in making all settlements among members. The economic effect would be little different from the gold standard itself. It would operate like the gold standard with some reserve units added. Like a return to the gold standard itself, it could call into question the continuing usefulness of reserve currency holdings and would probably encourage the conversion of some holdings into gold. To the extent such conversions should occur, the world would face a decline in total world liquidity, rather than an increase.

A second important condition would be that dealing with the manner in which decisions would be made for increasing or, if necessary, decreasing the amount of units in existence. To oversimplify, it would be in the apparent interest of creditor countries to resist—and of debtor countries to favor—the creation of additional units. If new issues were to be subject to a unanimous agreement, which is to say if any country could veto an expansion or a contraction, it would hardly be accurate to say that decisions regarding the adequacy of international

liquidity had been placed under international control in any meaningful way.

The importance of the conditions which might govern creation of new assets would be no less if new reserve assets should be created in the International Monetary Fund. Proposals of this type call for creation of claims on the Fund that can be drawn upon at will to meet balance of payments deficits. For example, automatic drawing rights could be accorded against some part of the existing credit tranches in the Fund. Another proposal is that the Fund might be authorized to invest some of its holdings of currencies in member countries, thereby providing those countries with assets usable internationally.

Again, a number of questions would have to be considered. Would operation of the normal weighted voting procedures in the Fund serve the interests of creditor and debtor countries equitably? Should reserve assets be created for all countries or for only those countries that might be expected to be in both surplus and deficit over a period of years?

However additional reserves are created, their use implies a credit operation. The original creation could take the form for each participating country of an equal increase in its liabilities and in its assets—the latter becoming, by terms of the agreement, an international reserve asset. There would be no real economic impact at this stage. But as soon as the newly created asset or unit began to be used, those surplus countries which accumulated the unit would be extending credit to the deficit countries. And the extension of credit from one country to another reflects the transfer of real assets. The surplus country forgoes present consumption in exchange for higher reserves, or for future potential consumption. A creditor country has, of course, considerable freedom of action in controlling the credit it will extend. There are many acceptable ways in which a balance of payments surplus can be reduced. Study of the adjustment process to determine appropriate policies to be followed—both by deficit countries to correct their deficits and by surplus countries to reduce their surpluses—is another area to which the Group of Ten is giving attention.

With respect to the deficit countries, no country can expect to receive unlimited automatic credit from its trading partners. The search for assurance that adequate international liquidity will be maintained in the future will not in any sense be a search for automatic credit for persistent debtors.

I have mentioned a few of the issues connected with the liquidity discussions without giving any clear indication of what the answers should be. The answers must await continued hard study and, at an appropriate stage, perhaps hard negotiations. I will advance only three questions for your consideration at this time.

First, how can we make certain that any new scheme will be entirely compatible with the evolution of the existing system? This will require that nations should not be penalized, nor benefited, as a result of the composition of their reserves, when and if some new liquidity asset is developed.

Second, how can we assure that any new system will increase and not reduce world liquidity? World liquidity would be reduced to the extent that existing reserve currency holdings are converted into gold.

What, then, should be our attitude toward proposals which might stimulate such conversion or cast doubt upon the stability or the convertibility of existing reserve currency holdings?

Third, how can we make sure that any new system will maintain machinery for giving appropriate weight to the views of both creditor and debtor countries? Should it be subject to the arbitrary control of either, or to the veto of a single country?

These are three broad questions, among many, that will need to be kept in mind as we proceed to examine most carefully the various ideas that have been or may be suggested. We are conscious that the creation of any new type of reserve asset by international agreement would be a step of profound significance. We must be sure that it is a step in the right direction. The mechanism of the international monetary system is an intricate and complicated mechanism, the successful functioning of which is of worldwide concern. We must make certain that any adjustments made in that mechanism will be the best that experience and intelligence and concern for the welfare of all nations can devise.

EXCERPTS FROM THE REMARKS OF HON. MERLYN N. TRUED, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. TREASURY, BEFORE THE INSTITUTE OF HIGHER STUDIES, UNIVERSITY OF NAVARRO, BARCELONA, SPAIN, JUNE 16, 1965

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It is quite clear that a correction of the U.S. balance-of-payments position is necessary if attention is to be turned in meaningful fashion toward further reinforcement of the payments system. But we will achieve this correction and we will share, along with other nations of the free world, the clear responsibility to assure that the payments system remains adequate and responsive to emerging needs.

As I have noted earlier, the vast gains made over the two decades since World War II have been facilitated by a payments system that has been highly flexible and adaptive. The payments system has had the benefit of using a monetary unit, the dollar, which can slide smoothly through the exchange markets, through private hands and through official channels—a fact which, I suggest, is of great importance to the private sector.

In any event, in looking forward certain broad-range possibilities are clearly evident. It would seem useful in considering future developments to give attention first to the possible needs in the private sector in order to insure that the financing needs of trade are fully met. As I noted earlier, dollar holdings in the hands of private foreigners have about doubled over the past decade, roughly the same change that has taken place in world trade. This contrasts sharply with the experience in the second decade after World War I—a testament to the worth of an entirely different approach by the free nations to their interrelationships.

What has been accomplished over the past 20 years reflects a high degree of cooperation among the free world's nations. It seems to me quite evident that cooperation must continue if the future is to prove equally rewarding. All have a responsibility for making the system perform well and there is no automatic answer for the widely differing and increasingly complex problems that face us both individually and collectively. Certainly it may be expected that one country or another will, in the future as in the past, be able for a time to follow a path widely divergent from the mainstream of thinking among financial officials generally. But for many nations to ignore the basic need for cooperation and a sharing of responsibility is to invite trade-shattering results and serious deterioration in standards of living generally—a situation unattractive to contemplate.

Given a minimum of cooperative and responsible action in the future as in the past, the outlook is highly promising.

We are, of course, particularly conscious of the role of the dollar as a currency facilitating the international exchange of goods and serv-

ices. Similarly, we are conscious of the great need, over time, to inspire confidence in its stable value and its unrestricted use for wide-ranging, useful purposes. In concentrating attention upon official reserves, their needs and composition, we must remain also keenly aware of the day-to-day needs of private trade, and remember that official confidence can mirror as well as affect private confidence.

In viewing these private needs, it is difficult to conceive of—accounting, perhaps, for the fact that no one has suggested it, so far as I know—the introduction into the system of a totally new or arbitrary unit which could serve quite as well as a national currency, dealt in and held by financial institutions and traders as a matter of course and as part of their normal working requirements. Indeed, I would firmly expect the dollar to continue to serve as the world's primary trading currency, and I see no insuperable difficulties in assuring its availability to meet private balance requirements.

This role of the dollar in past years is highlighted when one compares the results on the U.S. balance of payments as presently calculated with alternative methods. As you may know, we in the U.S. Government are now studying one possible alternative, the official settlements concept, that has been recommended by a committee of distinguished economists, bankers, and businessmen headed by Dr. E. M. Bernstein. If this alternative method were used, the deficits over the past 5 years would have totaled about \$12½ billion rather than \$17 billion, and the trend would have been distinctly downward from \$3.5 billion in 1960 to \$1.5 billion in 1964 instead of remaining in the area of over \$3 billion.

Although these private holdings of dollars have increased substantially over the years, the rate of increase from year to year has fluctuated sharply, and we must be conscious of the potential shiftability of the dollar between private and official hands. For this and other reasons as well, the use of the dollar as a trading currency does imply a special responsibility for the United States in maintaining ample international resources and, more broadly, there is sure to be a related need for higher official reserve availability.

Gold, quite clearly, will not fully meet this need—although some further refinement and strengthening of official operations in gold might well serve to secure an increased proportion of new production for official holdings, the place where gold serves its most useful purpose. But one can predict that gold will not prove adequate, and one may with equal confidence predict that the United States might find it either inconvenient or perhaps embarrassing to run a deficit—at the expense of its own net reserve position—simply to supply official reserves needed by “the rest of the world.” Other possibilities, therefore, have been explored and are being explored, most notably in the International Monetary Fund and the Group of Ten.

To the extent that the problem is viewed as one of assuring that financing is available to deal with short-lived fluctuations in private balances or recurrent swings in balance-of-payments positions, the solution could, at least largely, lie in the range of improved credit availability. Some further reinforcement in the International Monetary Fund's resources could well serve this purpose. A reinforcement of the Fund's resources could serve over time to contribute to a secular growth in reserve availabilities, if, for example, ways could be found

to substitute a relatively dormant gold certificate for the gold payments now made to the Fund at the time of a quota enlargement.

Another means of reducing the impact of U.S. payments surpluses on liquidity needs would lie in the accumulation by the United States of holdings of other foreign exchange. To some people this seems a simple matter of reciprocity. If others build up their holdings of dollars when the United States is in deficit, why shouldn't the United States build up its holdings of foreign currencies when it is in surplus? The extent to which such holdings could increase depends upon a number of factors, but this possibility should not be overlooked. Given a willingness on the part of other countries to permit their currencies to be effectively convertible, and with greatly improved chances that the currency instability of the past will not be characteristic of the future, there is good reason to assume that some addition to liquidity could be carried out in this manner. The reluctance of countries to have their currencies so held, partly because of a lack of market which provides ready investment facilities and partly because of other institutional controls over market activity, might well, hopefully, decline in the future. And if some of the major currencies abroad were to become more closely linked and perhaps even a uniform currency devised, the potentiality of this course of action might be improved.

Some further reinforcement of the system might be possible as a result of concerted action to devise supplementary assets to be held in official reserves. Perhaps the key to a successful search in this regard lies in constructing various types of assets with differing characteristics as regards the earnings from holding the asset, the maturity and liquidity of the asset and the degree of formalized assurance against change in its exchange value. By being able to select from a range of portfolio possibilities, the willingness of financial authorities to hold higher amounts of aggregate reserves might be increased. The possibilities are quite numerous but certainly a vast proliferation of supplementary assets should be avoided in the interest of an orderly and efficient system.

As you know, the methods of creating reserve assets have been under study by a committee of the Group of Ten. In seeking to determine whether and when new types of assets might be appropriately fashioned, a related study is also of importance. This study is one that explores the mechanism by which countries adjust to imbalance in their positions. The need for aggregate reserves of a particular size depends in good part upon the depth and tenacity with which imbalances in a particular country's position occurs, as well as the availability, character, and magnitude of credit facilities. To the extent that market instruments, techniques, and institutions, along with fiscal and monetary policies, are fully available to deal with maximum effectiveness in solving deficit or surplus problems, the need for increased reserve assets in official reserves is reduced.

The challenge of insuring a payments system that performs equally as well in the next two decades as it has in the past two decades is a real one. And I would not, in concentrating upon these possibilities, wish to exclude an appropriate role for bilateral instruments and techniques that serve importantly to safeguard against abrupt and serious threats to stability in the foreign exchange markets or serve to

meet the needs of the two parties concerned in the particular circumstances that might prevail at a given time. Certainly, these techniques, some of which have been introduced into the system with immense benefit, will also continue as an appropriate facet of the system.

As we consider possible improvements in the payments system of the future, it is important that we alertly avoid falling into the trap of thinking that completely formalized arrangements are always more dependable than the less formal, or that rigid guidelines always assure greater stability than would less rigid, more adaptable rules. The flexible and adaptable payments system of the past and present, responsive to emerging needs, as I have pointed out, has facilitated vast progress. In viewing future arrangements to correct any weaknesses, the strengths and the stability of that system should not be cast lightly aside. A degree of responsiveness and flexibility must be retained—to help insure that needless rigidity does not bring abrupt and shattering points of conflict.

EXCERPTS FROM REMARKS BY HON. FREDERICK L. DEMING, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS, AT THE ANNUAL CONVENTION OF THE WASHINGTON STATE BANKERS' ASSOCIATION, TAKOMA, WASH., JUNE 22, 1965

INTERNATIONAL BANKING IN RELATION TO THE BALANCE OF PAYMENTS AND TO INTERNATIONAL LIQUIDITY

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Actually the growth in liquidity in the past 10 years has been concentrated largely in the surplus industrial countries. When we look at the position of international reserves and their recent growth, we are struck at once by the really phenomenal enlargement of reserves in the industrial countries, excluding the United States and the United Kingdom. From the end of 1953 to the end of 1964, the gold and foreign exchange reserves of eight leading industrial countries in the Group of Ten and Switzerland rose from \$10.6 to \$27.6 billion, or by \$17 billion. This amounted to nearly tripling their total reserves.

Moreover, during this period, while these countries increased their reserves in gold and foreign exchange, the rest of the world lost about \$3 billion of reserves in this form.

It is especially worthy of note that the demand of these countries for gold to add to their reserves, at \$12 billion, was about twice the availability of new monetary gold supplies for the world as a whole. This was made possible only by large-scale transfers of gold to them from U.S. reserves.

I do not attempt today more than to sketch out some of the relationships between international capital flows and our balance-of-payments and liquidity problems. As and when our balance of payments shows continuing strength, some of the uncertainties that have to date surrounded the liquidity problem should begin to clear. We can then see what we face, once the all-embracing screen of the massive U.S. deficit has been lifted and moved aside. The essential questions that will have to be answered are: What will be the reserve needs of the world? How much will the major industrial countries require in the form of gold, and what will they be willing to take into their reserves in addition to gold?

There are a number of technical possibilities for creating additional reserve assets to meet these or other situations in the future. They involve essentially an agreement or understanding among monetary authorities to treat a particular type of credit claim, either on another country or on an institution, as a monetary reserve asset.

One method, frequently mentioned, is the further extension of the technique of reciprocal acquisition of currencies, as in the short-term swaps of the Federal Reserve, but for a long term. Each country then

regards its claim on the other partner as a reserve asset. The countries could also issue special securities to each other, with appropriate provisions as to maturity, interest rates, and exchange protection.

Another approach would be a further evolution of the present reserve claims on the International Monetary Fund. These claims are drawing rights that countries have obtained, and can use virtually at will, as a result either of having paid gold subscriptions to the Fund, or from the use of their currencies by the Fund to extend credits to other countries. The Managing Director of the Fund, Mr. Schweitzer, has recently indicated how this might be done, either by increasing the present readily available drawing rights or by creating special claims on the Fund to be used as reserve assets.

Other suggestions have been made involving more restrictive procedures, both as to participation and governing rules. I do not propose to comment in any detail on any of these approaches. However, I would like to underline some of the characteristics of any approach which seem to me especially significant.

First, additional or new reserve assets should be accepted as such by the major industrial countries. Secondly, they should be held as reserve assets without directly or indirectly leading to a reduction in reserve currencies or other supplements to gold reserves. That is, they should not accentuate demands on gold. Thirdly, the method of providing additional reserves should be in general evolutionary, in the sense of general public acceptance with a minimal disturbance of financial and exchange markets and with especial care to avoid encouragement to gold hoarding and gold speculation. Fourth, a balance would have to be achieved between the fears of some that creation of international reserves becomes too easy, with a general overexpansionary effect on world supplies of money and credit, and those who fear that international decisions would be too cumbersome and too restrictive. There are, of course, many other questions that might divide proponents of this or that technique, or appeal to particular countries, including the always important questions of who participates in the benefits and responsibilities of reserve creation, and how they are shared.

Reserve assets, once created, in a satisfactory way or ways, could be shifted from country to country and earned or borrowed in ways similar to gold, reserve currencies, or existing claims on the Fund. That is, they could make possible the simultaneous existence of surpluses among the major countries, including the United States, in excess of new monetary gold supplies, and without redistribution of existing gold reserves or cancellation of other reserve assets. They would then be true supplements to existing reserves.

A consensus may not emerge easily or quickly. For the world has to date relied essentially on gold and reserve currencies, and the public everywhere tends to be cautious and pragmatic in monetary matters. Money is peculiarly sensitive to public acceptance and public confidence.

We shall not find answers to these questions overnight. Indeed, the answers can probably evolve only as they are shaped and molded by the actual course of monetary history in the making. What we must insure is that the monetary authorities of the world have a com-

mon awareness of the type of problem which may arise as dollars become more scarce and have a common objective of shaping the evolving international monetary system in a cooperative way to the benefit of the sound economic aspirations of developed and developing nations alike.

THE FUTURE OF THE DOLLAR AS INTERNATIONAL MONEY

(James Tobin, professor of economics, Yale University, Carl Snyder Memorial Lecture, University of California, Santa Barbara, March 23, 1965)

As General de Gaulle has characteristically reminded us in his February 4 press conference, the U.S. dollar occupies a unique position among national currencies. It is used as money throughout the world, not just in the country of issue. Will the dollar continue to perform this special international role, lately called into question by events as well as by the General? Does the United States have a national interest in the perpetuation of this external use of its currency? In what alternative ways could the international functions of the dollar be performed? These are the questions I should like to discuss with you this afternoon.

Foreign users of dollars are both private (banks, businesses, and individuals) and official (central banks, governments, and international institutions). I shall discuss both. For reasons that I shall develop, I believe there are good prospects for continuation and even expansion of private uses of dollars. However, I think the dollar is likely to lose, sooner or later, its position as a "reserve currency" for central banks and governments. I will explain why I feel we should not be dismayed by this development, and I shall discuss some suggestions for replacing the dollar in the international monetary system.

Today, foreign holdings of dollars amount to \$24 billion, of which private holdings represent \$11 billion and official holdings \$13 billion. I exclude international institutions, which hold another \$5 billion. I refer to foreign holdings of dollars, but of course I do not mean dollars in the literal sense of coin and currency. Very little takes that form. Rather, I am speaking of obligations to foreigners payable on demand or within a year by U.S. banks or the U.S. Treasury. Increases in these liquid short-term liabilities to foreigners are what we count, together with outflows of gold, as deficits in our balance of payments.

FOREIGN PRIVATE DOLLAR HOLDINGS

Why do private banks, businesses, and individuals abroad hold dollars rather than their own national currencies? Sometimes, of course, they are speculating that their own currency may depreciate in value. Normally however, these dollar holdings are working balances, maintained in preparation for making future dollar payments. They are analogous to the working bank balances of American households or corporations. The dollar is the unit of account, and medium of exchange, not only for the \$40 billion of annual payments by foreigners to U.S. residents but for many other transactions in which neither party is a U.S. resident.

The dollar plays this role for several reasons. One is simply the size of the country and of its transactions with the rest of the world. Another is historical. After the Second World War, the dollar and the Swiss franc were the only currencies convertible on demand into any other national currency. Other currencies were subject to all kinds of exchange controls, and to considerable risks of devaluation. The dollar's value was assured, and less by U.S. possession of almost all the world's monetary gold in the free world than by the seemingly inexhaustible appetite of foreign countries for U.S. products. In these circumstances it was natural for exporters and importers, lenders and borrowers, to make their contracts in dollars. A third reason is the high state of organization and efficiency of U.S. financial institutions and financial markets. The holder of a working balance naturally seeks to earn some interest return on his funds. Likewise, he wishes to be able to put funds in or take them out at any time conveniently, inexpensively, and quickly. The only places which really offer such facilities, through banks and a short-term money market, are New York and London. The checkered career of sterling since 1931 has confined its use as international money pretty much to the "sterling area," composed mainly of Commonwealth and ex-Commonwealth countries.

THE EURO-DOLLAR MARKET

During recent years, it is true, strong competition with New York has developed in London and elsewhere in Europe. The new institutions and markets pay the dollar the sincerest kind of flattery. For they deal in "Euro-dollars"; i.e., short-term liabilities to pay dollars undertaken by foreigners rather than by American residents. When the debtor is a reputable London bank, his promise to pay dollars is virtually as good as "real" dollars in New York.

Euro-dollars are substitutes for real dollars just as bank deposits are substitutes for the coin and currency which they are obligations to pay. Thus the development of Euro-dollars has reduced world demand for dollars. Not of course one for one. Banks and other dealers who have undertaken Euro-dollar obligations presumably keep some genuine New York dollars as reserves. Otherwise they might have to scramble to raise the dollars needed to meet their dollar-denominated obligations when they come due.

Of course they make loans expressed in dollars too. But, as in any banking operations, the loans are less liquid and more risky, as well as higher yielding, than the deposits. This difference is responsible both for the profit in the operation and for the need for fractional reserves. I don't know what the reserve fraction is in the Euro-dollar market, but it is probably quite low. Even if it were as high as one-fifth, every Euro-dollar substituted for a real dollar in international working balances would mean a net reduction of 80 cents in the demand for dollars.

The major attraction of Euro-dollars has been that they pay a higher interest rate than deposits in New York or U.S. Treasury bills. At the same time, Euro-dollar market banks are able to make loans at rates competitive with U.S. lenders. The profit opportunity which has called forth the Euro-dollar market is the gap between deposit interest rates and loan interest rates in the United States. This gap

was in part due to the legal ceiling imposed in the United States on the rates commercial banks may pay on time deposits. Although the Federal Reserve has raised this ceiling in several steps over the past 3 years, it still handicaps the United States in the international competition for funds. The ceiling should be abandoned altogether.

So far as foreign demand for dollars is concerned, the obvious reduction due to substitution of Euro-dollars is offset only to the extent fractional dollar reserves are held against Euro-dollars which are substituted for holdings of other national currencies. The offset cannot be large, although I do not know of any successful attempts to pierce the mysteries of the Euro-dollar market and measure these effects.

The economy of dollars accomplished by the Euro-dollar market is by its nature a once-for-all phenomenon. The dollar may already have survived the main blow it is going to suffer from this source. Once the initial profit opportunity is exploited—and Euro-dollar rate margins are very narrow now—the market will grow at roughly the same pace as the world economy, and so will its need for genuine dollar reserves.

Besides the competition of Euro-dollars, adverse speculation has reduced private demand for dollars in recent years. In spite of these two disadvantages, private dollar holdings abroad have been rising by about \$1 billion a year. This seems to me impressive testimony of the strength of the world economy's normal demands for dollars for working balances. In satisfying these demands, we can probably run a balance-of-payments deficit, according to the Commerce Department definition of the term, of \$1.5 billion a year without putting the dollar under pressure in the foreign exchange markets

OFFICIAL DOLLAR HOLDINGS

I turn now to the official use of dollars. Some official holdings are working balances, similar to the private holdings I have just been discussing. The central banks of other countries are committed, under the articles of agreement of the International Monetary Fund, to maintain the values of their currencies in the foreign exchange markets within 1 percent of the declared official parities. They do this by buying or selling dollars for their own currencies. They have working balances of dollars both as a result of and in anticipation of their interventions in the exchange markets.

But the current dollar holdings of foreign central banks and governments greatly exceed their needs for working balances. The dollar has been used as a reserve currency, and the bulk of official holdings abroad represent reserves which nations hold against adverse developments which threaten their exchange rates or their ability to pay for needed imports.

Gold is the most important reserve asset. But, especially after the Second World War, many nations began to use dollars in place of gold or in combination with gold. Dollars could earn interest; they were directly usable in the foreign exchange markets; they were convertible into gold at the U.S. Treasury; they commanded American goods and services. Until the late fifties, therefore, the United States could count on foreign central banks to hold gladly any dollars which came their way. In those years, as in the sixties, the United States regularly ran balance-of-payments deficits. But no one noticed them, because

they provided foreign countries with reserves in a quantity and a form they wanted.

This buildup of dollar reserves, moreover, served an important international purpose. Without them, Europe and the rest of the world could have built up their own reserves only by depleting the U.S. gold stock. This would have forced the United States to take, early in the postwar period, deflationary and restrictive measures. New gold production is not able to keep pace with the demand for reserves in a growing world economy.

The reserve currency system grew like Topsy; it was never deliberately and consciously created. But its internal logic is that foreign countries will accept unlimited quantities of dollars in payment for their goods and their properties. As General de Gaulle and his unofficial monetary adviser, M. Jacques Rueff, have so eloquently pointed out, the principle of the reserve currency system is indefensible. It is as if an individual citizen of the United States had the power to print dollar bills for his own use. We have long since centralized and nationalized the power to create national currency. For similar reasons General de Gaulle is unassailable when he asks that international money "not bear the mark of any individual country."

Of course the reserve currency system has not been operating according to its internal logic in recent years. On the contrary, the United States has been faced ever since 1960, at the latest, with the distinct possibility that General de Gaulle and others will ask us to convert into gold not only the dollars currently accruing to them but also those which they happily accepted in the halcyon days of the reserve currency system. This has made our supposedly privileged position much less comfortable, to say the least, than it would be if dollars really continued to be the unquestioned equivalent of gold.

I do not think it is simply nationalistic bias that leads me to assert that the United States did not abuse the privileged position of owning a printing press for international money. We did not flood Europe with worthless paper, forcing them into inflation while we carted home the products of their toil and thrift. On the whole, we used our international monetary privilege to finance the responsibilities we had assumed in the common defense of the West and in assistance to the underdeveloped world.

It is true that American investors have been acquiring large and presumably profitable industrial and commercial interests in Europe. As a nation, we have financed these acquisitions by pouring dollars into European central banks. It would be hard to judge whether this is an abuse of the reserve currency system, or whether it is a result of the formation of a customs union which at the same time attracts American capital and excludes American exports. But in any event a European country with nationalistic objections to the U.S. capital invasion can handle the problem by direct measures. Were the international monetary system otherwise satisfactory, the fact that it has facilitated this movement of capital would not be a reason for changing it. Indeed facilitation of capital movements is one of the principal *raison d'être* of the system of fixed exchange rates.

But it is really beside the point to argue whether or not the United States has abused, or is abusing, its reserve currency status. General de Gaulle's monetary restlessness is of a piece with his general rest-

lessness, shared in some measure by other European governments. Europe will no longer accept without question and participation U.S. international leadership, no matter how benevolent. We will undoubtedly have to construct more symmetrical arrangements for making international decisions and sharing international responsibilities in the fields of defense and foreign aid, as well as more symmetrical international monetary arrangements.

Some countries, particularly those in the Western Hemisphere, may continue to find it in their interest to hold the bulk of their reserves in dollars because of their close trading ties with the United States. Similar arrangements exist within the sterling area, and within the franc zone, which includes most of France's former dependencies in Africa.

In particular, the United States and Canada may find it in their mutual interest to move toward a monetary union. We would give Canada a large line of credit; in return Canada would agree to hold all its reserves, above a minimal gold stock, in U.S. dollars. This would formalize what is already true; i.e., that a consolidated North American balance of payments is of much greater relevance to the strength of the two dollars than their separate accounts. Capital outflows across our northern border should not really be a cause for concern about the U.S. dollar, as they are in present statistical practice. Such outflows tend to be offset sooner or later by Canadian imports from the United States or by increased holdings of dollars by the Bank of Canada.

Outside a "dollar area," however, I believe that we in the United States must face squarely the inevitable prospect that other countries will cease to hold dollars as official reserves above minimal working balances. They will insist on a more symmetrical or neutral international money. Recent French conversions of dollars into gold are a dramatic indication. Perhaps the handwriting on the wall can be read even more clearly from the unobtrusive way in which Germany, which has no political reason to embarrass the United States, has been steadily reducing the dollar content of its reserves. And even when conversions are not made, the threat hangs over our heads like the sword of Damocles and forces us to take all kinds of measures which conflict with U.S. foreign and domestic policy.

ALTERNATIVES TO THE RESERVE CURRENCY SYSTEM

What could take the place of the dollar in official reserves? And how could the transition to a new kind of international money be arranged?

THE GOLD STANDARD

One proposal, of course, is to adopt a pure gold standard. Nations would hold only gold metal as international reserves. Balance-of-payments deficits resulting in claims by one central bank upon another would be settled in gold. Presumably central banks and governments might extend each other credit. But deficit countries would have no automatic or presumptive rights to such credit. This is the system favored by Jacques Rueff, among others.

Any abrupt institution of the gold standard would involve massive conversion of dollars into gold. U.S. gross reserves would drastically

decline, and total world reserves would contract by an equivalent amount. To avoid this shock, most advocates of the gold standard solution favor an increase in the price of gold in terms of all currencies. By marking up the value of its gold stock by 66⅔ percent, the United States would be able to pay off \$10 billion of its short-term debts in gold and still have, as now, \$15 billion in gold reserves. Other countries' reserves would be increased by two-thirds of their current gold stocks. Most gold standard advocates would regard this expansion of world reserves as inflationary. They would prefer an increase in gold price of the order of 33⅓ percent, which would be just sufficient to enable reserve currency holdings outside the currency "areas" to be replaced by gold without changing the total of world reserves. In this case the United States would have only \$10 billion in gold left after the two operations, revaluation of our stock to \$20 billion and conversion of \$10 billion of outstanding dollars. Our loss of \$5 billion in reserves would be balanced by increases in the reserves of other countries.

All major governments have repeatedly opposed this solution and expressed their determination to avoid it. The main national beneficiaries would be South Africa and the Soviet Union, the principal gold producers. The main private beneficiaries would be the gold speculators and hoarders who have already caused so much trouble. A rise in the gold price now would encourage similar speculation and hoarding some time in the future. It would put more world resources into an essentially wasteful activity, and even so there would be little prospect that gold production would augment reserves at a sufficiently rapid or regular rate to meet the needs of an expanding world economy. Surely in this day and age man can contrive a better solution than to reinforce the ancient irrational myth of gold.

THE COLLECTIVE RESERVE UNIT

The French Government has promoted discussion of one alternative scheme, the collective reserve unit or CRU, and I suspect this, rather than a literal metallic gold standard, was in the back of General de Gaulle's mind. In its essence the proposal would increase the value of gold in official monetary gold stocks, but not the value of unmined or privately hoarded gold. CRU's, which may be regarded as paper gold, would be issued to participating nations roughly in proportion to their gold stocks. They would be issued by an agent—the French propose the Bank of International Settlements in Basle—with whom the participating countries would deposit equivalent amounts of their own currency. Thus a CRU would represent, say 50 cents in U.S. dollars, 10 cents in French francs, 12 cents in German marks, and so on. Deficits would be settled in gold-cum-CRU's in fixed proportions corresponding to their shares in aggregate reserves.

CRU's would replace dollars in monetary reserves. Assuming the initial issue was designed to change the form but not the total of reserves, it would be about one-third of the aggregate monetary gold stock and have the same effect on U.S. and foreign reserve positions as a 33⅓-percent increase in the price of gold.

The CRU proposal has two great merits. It would be a truly international fiduciary money, based on a portfolio of national currencies rather than any single national money. It is vastly superior to

gold, because no resources need be wasted in producing it; and its supply can be deliberately controlled rather than left to the accidents of mining economics and technology and the whims of private hoarders and the Soviet Union. Nevertheless, the proposal has decisive disadvantages for the world, and particularly for the United States.

First, the French wish to confine the participating group of nations to a big boys' club—10 or 12 leading monetary powers. These countries would print more money for themselves, and from this new mine of paper gold the rest of the world would benefit only indirectly. There already exists a worldwide monetary organization, the International Monetary Fund. The French proposal would diminish its importance by entrusting the most important monetary function to a select group, outside or only nominally inside the Fund.

Second, replacement of existing dollar holdings with CRU's, of which the dollar component if only fractional, inflicts on the United States a considerable loss of total reserves. As I argued above, the United States need have no apologies for the past. Its deficits were incurred for good international purposes and were essential to the international monetary system. We should insist that any new system consolidate the past without penalizing the United States. The first installment of CRU's should be backed 100 percent by the dollars they replace in foreign reserves.

Third, the proposal has a restrictive and deflationary spirit and bias. This is not intrinsic to the proposal but reflects the French view that the current total of world reserves will be adequate for some time to come. They wish the new system to function like the gold standard described above, in which countries have very little access to credit to relieve the necessity of settling deficits with metallic or paper gold.

In principle, the participating countries could regulate the supply of world reserves by agreeing to issue themselves from time to time new CRU's, in the agreed national proportions. But since this would require a unanimous vote, doubts would probably be resolved by doing nothing.

THE INTERNATIONAL MONETARY FUND

The major alternative is to replace dollars with credits against the International Monetary Fund. The Fund already is a pool of national currencies from which members can draw. Some of their drawing rights are automatic; these should be, and increasingly are, regarded by member countries as international reserves on virtually the same plane as gold and reserve currencies.

These automatic rights arise in two ways. First, 25 percent of members' quotas are subscribed in gold, the remainder in their own currencies. The gold "tranche" is automatically available. The total of gold tranche rights is now about \$3.5 billion, and it will rise to about \$4.5 billion under the 25-percent increase in Fund quotas which has just been negotiated. Gold tranche drawing rights do not augment world reserves, since they only replace the gold paid into the Fund by member governments.

Second, a fiduciary creation of automatic drawing rights occurs as a byproduct of Fund lending operations. For example, in the past when the Fund lent dollars to other members, typically underdeveloped countries, the United States obtained new automatic drawing rights—so-called pre- or super-gold-tranche rights—in equal amount.

To the extent that the borrowing countries were using not solely the gold tranche of their quotas, but the nonautomatic credit tranches, the new automatic rights created for the United States were not offset by any reduction in the automatic rights of other members. In recent years the United States was able to use more than \$1 billion of rights previously accumulated in this way to finance its balance-of-payments deficits. At present, the net automatic rights of Fund members deficit in this way amount to about half a billion dollars.

There are several ways in which the IMF could create more reserves than it has in the past. One is to make another 25 percent of quotas, the first "credit tranche," as automatic as the gold tranche. This would increase world reserves by more than \$4 billion initially. It would also mean that future increases in quotas would add to world reserves more than they subtract in gold subscriptions.

A second device, which also has considerable appeal to me, is for the Fund to engage in investment operations. The Fund would purchase national currencies with pre-gold-tranche drawing rights. Members would share in their purchases in fixed proportions, probably governed by their relative quotas in the Fund. Fixing the proportions has the advantage of avoiding highly arbitrary political decisions each time an operation is undertaken. It makes these reserve creating investments essentially neutral monetary operations, like the open-market operations of national central banks. They would be clearly distinct from extensions of credit to help individual countries, which are analogous to the discounting functions of national central banks.

There may be objections to Fund investments in the obligations of members with inconvertible currencies, which are not usable in Fund drawings. To meet these objections while still giving the underdeveloped world a share in the benefits of Fund reserve creation, an appropriate proportion of Fund investments could be reserved for purchase of the obligations of the International Bank or its affiliates.

Finally, it is essential to avoid total inaction whenever there is disagreement. Therefore, it should be provided that, unless the Fund board specifically votes to do otherwise, Fund investments in any year should be sufficient to make total automatic drawing rights grow by an agreed percentage. The chosen figure should be designed to make total world reserves, including gold as well as IMF credits, expand along with world trade and production.

Simultaneously, the usefulness of automatic drawing rights on the Fund could be increased by making them directly transferable between members. At present they can be shifted from one member to another only with the intervention of the somewhat cumbersome currency-drawing procedures of the IMF.

As just outlined, the proposal does not solve the transitional problem of consolidating existing dollar balances. This too could be done by the Fund, through an initial purchase of dollars from the countries now holding them. Or, it could be done separately, outside the IMF, by funding our current short-term dollar debts into long-term debts payable in the other country's currency. The attractiveness of this funding could be enhanced by providing that the lending country could cash them early, with the United States, another country, or the Fund, in case it encountered balance-of-payments difficulties of its own.

The proposal for Fund investment in a package of national currencies and World Bank bonds has obvious kinship with the CRU

idea. But it avoids the disadvantages of the CRU. It is located in an established worldwide organization, and all countries share in its benefits. It does not replace existing dollar balances in a manner unfair and injurious to the United States; this consolidation must be separately managed. The IMF investment proposal is flexible, and it does not have a deflationary or restrictive bias.

The creation of international money, for circulation among central banks, is entirely feasible. The institutional setting for this development already exists in the International Monetary Fund. The way is there; what is needed is the will. Progress is blocked, on the one hand, by French distrust of money creation in the IMF and, on the other hand, by U.S. insistence on the sanctity of the dollar's status as a reserve currency. In my view, the United States should now be willing to accept an orderly consolidation of dollar balances, in return for new arrangements to provide reserves through the IMF.

The United States no longer has blank-check privileges, and official holders of dollars are restless and unhappy. Nevertheless the U.S. Government continues to insist that we will consider no reform of international monetary arrangements which threatens the reserve currency position of the dollar. This insistence has contributed to the current impasse in international discussion of monetary reform. But it has not, of course, prevented the dollar's reserve currency status from eroding anyway.

The reluctance of U.S. financial circles to accept a solution which recognizes the decline in the reserve currency status of the dollar seems to be based on a misunderstanding. It is feared that such a solution will also displace the dollar from its role as the principal medium of exchange in private international transactions. This would lose New York and the country some financial business and income, and the Nation would no longer enjoy the ability to finance payments deficits from the yearly increment of private foreign demand for dollar working balances.

But no one is proposing to create an international money for private circulation. There the dollar will remain unchallenged, save for the imitative competition of the Euro-dollar. The sources of its advantages, which I tried to explain above, are in no way dependent on the dollar's continued use as an official reserve currency. Indeed, any international monetary reform which removes the danger of a run from dollars into gold can only strengthen the world's private demand for dollars. More important, it can free U.S. policy from our current obsessive concern with gold.

THE U.S. BALANCE OF PAYMENTS AND INTERNATIONAL LIQUIDITY

(By Edward M. Bernstein, June 18, 1965)

SUMMARY AND CONCLUSIONS

The measures taken by the United States to restore its balance of payments are already having a great effect on the international money market. Once the U.S. deficit is eliminated, there will be no net addition of dollars to monetary reserves. If monetary reserves do not grow over a period of years, this would place a severe strain on the international monetary system. That is why steps must be taken soon to assure the steady growth of monetary reserves on the scale which is essential to an expanding world economy.

The need for monetary reserves has been reasonably well met by gold and foreign exchange, supplemented by reserve credit from the Fund. But the increase of reserves over the past 30 years has been due to special factors that cannot recur. These are the change in the price of gold from 1931 to 1936, the wartime accumulation of sterling balances, and the sharp rise in foreign dollar holdings as a consequence of the U.S. payments deficit since 1950. While the prolonged deficit of the United States had the beneficial effect of creating additional reserves and of redistributing reserves on a massive scale, it must be eliminated.

Since 1958, the gold reserves of all countries excluding the United States increased by nearly \$11 billion. In the same period, the U.S. gold reserves decreased by \$7.4 billion. From 1958 to 1964, the foreign exchange reserves of these countries increased by about \$6.5 billion, while U.S. reserve liabilities increased by about the same amount. These reserves have gone to the surplus countries of continental Europe. At present, it can be said that aggregate reserves are adequate although not excessive. Once the U.S. balance of payments is restored, the growth of reserves will be sharply curtailed. Some other means must be found for providing a steady but not excessive growth of monetary reserves.

It has been suggested that the Fund be changed into an institution that would create monetary reserves through loans and investments. The creation of reserves by the Fund would be wholly at variance with the principles on which it was established. The Fund agreement states that its transactions are limited to providing currencies it holds to members in exchange for their own currencies or gold. The obligation of members of the Fund to provide it with resources for reserve credit is limited to their quota subscriptions, although the Fund may propose to a member that it lend its currency to the Fund. In any case, it would not be desirable to amend the Fund agreement to permit it to create reserves.

The best way of assuring an adequate growth of monetary reserves is by establishing a composite gold standard based on gold and Re-

serve Units consisting of the currencies of the Group of Ten and Switzerland. Each participant would be required to match its holdings of gold with Reserve Units in the ratio of \$2 in gold to 1 reserve unit and to convert balances of its currency held by other participants in this ratio. The Fund should be a party to an agreement to establish a composite gold standard and it should be allotted 25 percent of the Reserve Units created. This would be a recognition of the Fund as the central international monetary institution and it would enable the Fund to perform more effectively its function as the principal source of reserve credit.

THE U.S. BALANCE OF PAYMENTS AND INTERNATIONAL LIQUIDITY ¹

Effect of the U.S. payments program

The balance of payments of the United States has far-reaching effects on other countries and on the international monetary system. The special importance of the U.S. balance of payments to the world economy does not derive solely from the large trade of the United States, which is, of course, of great consequence to many countries. It is due, rather, to the predominant position of the United States as an international banking center, the large holdings of dollars as monetary reserve, and the wide use of dollars in international settlements. For these reasons, a payments problem in other countries inevitably has some impact on the United States as other countries draw on their dollar reserves and seek dollar credits to help meet their payments deficits. Even more important, when the United States takes measures to restore its balance of payments, the impact is certain to be enormous on international money markets and on monetary reserves.

After sustaining a large and prolonged deficit in its balance of payments, the United States is undertaking a voluntary program to restrain capital outflow. One feature of the U.S. program is to reduce the amount of net bank credit extended to foreigners from about \$2.1 billion in 1964 to about \$550 million in 1965. Another feature of this program is to have U.S. nonbank concerns withdraw liquid funds from abroad, so that instead of sending \$600 million to foreign financial centers, as they did in 1964, they may bring back an almost equal sum in 1965. The U.S. program for restraining capital outflow is already having a great impact on the international money market.

The success of the program for limiting the outflow of capital from the United States is evident in the sharp improvement in the U.S. balance of payments. Preliminary reports indicate that there was no deficit in March, April, and May, and the U.S. monetary authorities are determined to maintain a balanced payments position or a surplus hereafter. As the U.S. payments deficit has been the principal source of the growth of reserves in recent years, it is possible that the monetary reserves of all countries outside the Soviet bloc will not increase at all in 1965, even after allowing for gold payments to the International Monetary Fund in connection with the present increase of quotas.

From the point of view of the United States and of the world economy, it is essential to restore the U.S. balance of payments promptly.

¹ This paper presents the substance of three speeches by Mr. Bernstein in London (May 25), Paris (June 1), and New York (June 11).

Nevertheless, the problems that are emerging must be recognized and they must be dealt with promptly. There is no reason for believing that the pressure on the international money market or the decline in aggregate monetary reserves will cause a crisis in the world economy. But the severe tightening of international credit can cause difficulty in financing world trade and payments in the course of the next few months. This is an urgent problem. The best solution would be for the surplus countries of continental Europe to ease their credit restrictions sufficiently to supply part of the demand for credit that will be diverted from the international money market to national money markets. It is less urgent but even more important to strengthen the international monetary system in the near future. Since 1949, there have been 2 or 3 years in which the increase in monetary reserves has been negligible without adverse effects. What is important about monetary reserves is not how much they increase in any given year, but whether the average rate of growth is adequate over a period of years. That is why steps must be taken soon to assure the steady growth of monetary reserves on the scale which is essential to an expanding world economy.

Growth of monetary reserves, 1928-64

On the whole, despite difficulties experienced by some countries, the present international monetary system has worked very well. The need for monetary reserves has been reasonably well met by gold, dollars, sterling, and other foreign exchange, and reserve credit has been available on a generous scale from the International Monetary Fund and from arrangements made by the leading industrial countries with each other. Under the circumstances, it may be asked why any change is needed in the present system of providing monetary reserves. There are some countries that believe that the wide use of dollars and sterling as monetary reserves has certain basic defects, that it introduces an inflationary bias into the world economy, and that it may become the source of serious monetary instability. Whatever the merits of these views, the fact is that the present method of providing monetary reserves is excessively dependent on deficits in the U.S. balance of payments and that it is not in the interest of the United States or of other countries to permit the indefinite maintenance of such a deficit.

Although no conscious effort was made in the past to provide for the systematic growth of monetary reserves, there has been a large, and certainly an adequate, increase of monetary reserves over the past 30 years. There is no evidence that the present monetary reserves of all countries outside the Soviet bloc, consisting of nearly \$41 billion of gold and about \$24 billion of foreign exchange, is insufficient for the present level of world trade and payments. The enormous growth of trade in the postwar period is a clear indication that the expansion of the world economy has not been held back by a lack of reserves. The world is probably better provided with reserves today than at any time in the past 50 years, except for the brief period from 1934 to 1939. But this growth of reserves has been of an unusual character, dependent on special circumstances that cannot recur. This can be

seen from the factors that have contributed to the growth of monetary reserves since the great depression of the 1930's.

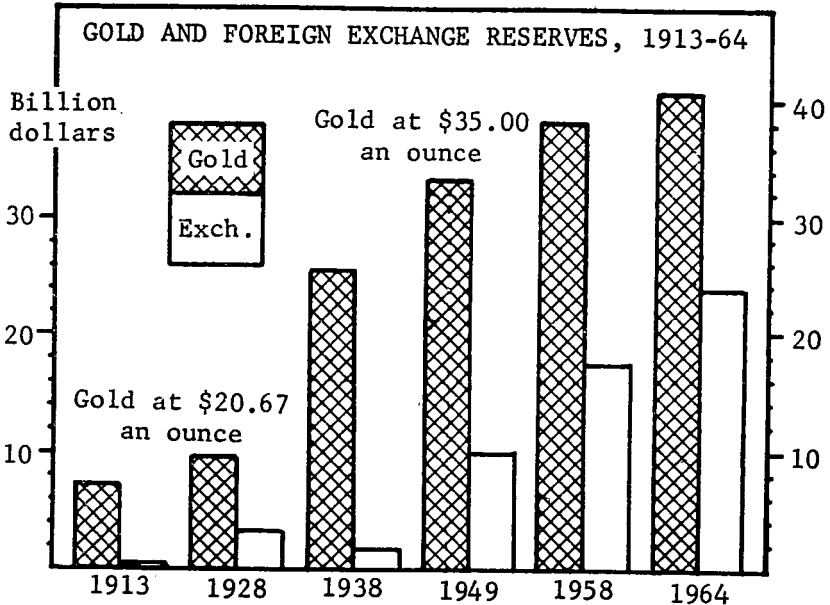
In 1928, the world stock of monetary gold, excluding the reserves of countries now in the Soviet bloc, was just under \$10 billion. The amount of reserves in the form of foreign exchange was about \$2.5 billion. By 1938, the world stock of monetary gold had increased to nearly \$25 billion, but foreign exchange reserves were down to \$2 billion. The large increase in the dollar amount of gold reserves was due to two factors—a 70-percent increase in the dollar price of gold and a 50-percent increase in the volume of monetary gold. Actually, the increase in the physical volume of gold was not notably large in these 10 years (about 4 percent a year), despite the much higher price of gold. This is the first special factor that brought about a large increase in monetary reserves.

From 1938 to 1950, the growth in gold reserves was relatively moderate—over one-third in 12 years (about 2.5 percent a year). In the same period, however, the foreign exchange reserves of all countries increased from about \$2 billion to about \$13 billion. Most of this increase was in the form of sterling. During the war, other countries, and particularly those of the sterling area, accumulated about £4,000 million in sterling, nearly all of which went into monetary reserves. This was the counterpart of the huge wartime expenditures of the United Kingdom abroad—for war materials and for military operations in the Far East, the Middle East, and Europe. This is the second special factor that brought about a large increase in monetary reserves.

From 1950 to 1964, the gold reserves of all countries outside the Communist bloc increased by about \$7 billion—just over 20 percent in 14 years (less than 1.5 percent a year). However, the increase of foreign exchange reserves in the same period was over \$11 billion. There was no increase in the holding of sterling as reserves—in fact, official holdings of sterling declined over these years. Nearly all of the increase in foreign exchange reserves was in the form of dollars and was attributable to the U.S. payments deficit. This is the third special factor that brought about a large increase in monetary reserves.

The causes and the effects of the once-for-all increase of reserves in gold, sterling and dollars show why this cannot recur. The general devaluation of currencies in terms of gold from 1931 to 1936 was the result of the independent efforts of the large industrial countries to halt the worldwide deflation. It was the only way that they could cope with the great depression because the scope of other national policies was severely restricted and international monetary cooperation was virtually nonexistent. The large accumulation of sterling from 1939 to 1946 was wholly caused by the exigencies of war. It has left the United Kingdom with a heavy burden of indebtedness and a greatly weakened reserve position. The increase of dollar reserves from 1950 to 1964 was the consequence of a prolonged payments deficit the elimination of which was too long delayed. While this greatly reduced U.S. reserves, it had the beneficial effect of creating additional

reserves needed by the world economy and of redistributing gold and dollar reserves on a massive scale.



U.S. payments deficits and reserves

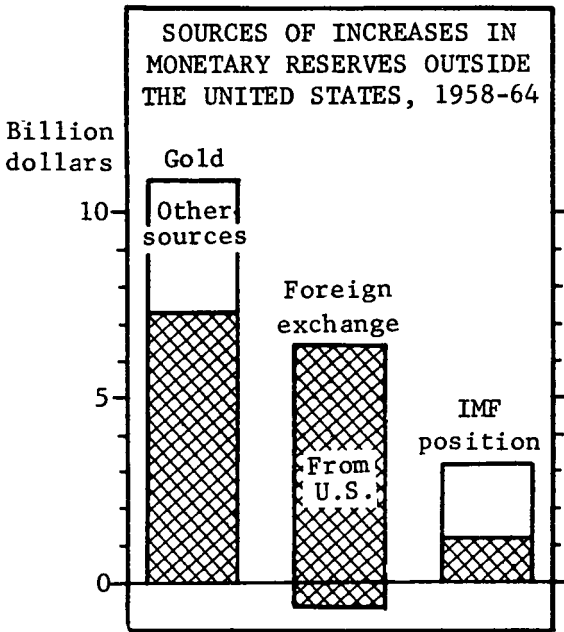
When the international payments of the United States for imports of goods and services, personal remittances, private capital outflow and U.S. Government grants and credits exceed the receipts from exports of goods and services and capital inflow, the excess accrues as dollars to the monetary authorities of other countries. Some of these dollars are converted into gold and the rest is retained by the monetary authorities. In either case, the reserves of the surplus countries are increased as a consequence of the U.S. deficit. In the 7 years from 1958 to 1964, the gold reserves of all countries outside the Soviet bloc, but excluding the United States, increased by nearly \$11 billion. Of this, about \$7.4 billion came from the decrease in U.S. reserves, without allowing for the U.S. industrial consumption of gold. The importance of the U.S. deficit was even greater, proportionately, in the growth of foreign exchange reserves. From 1958 to 1964, the foreign exchange reserves of all countries outside the Soviet bloc, but excluding the United States, increased by nearly \$6.5 billion. In the same period, the short-term claims of the official institutions of other countries, in dollar assets held in the U.S. money market, increased by about the same amount. There was also a considerable improvement in the net position of other countries in the International Monetary Fund and a deterioration in the U.S. position in the Fund.

This has been accompanied by an almost revolutionary change in the distribution of monetary reserves, particularly in the form of gold. At the end of 1949, the United States held 73 percent of the

gold reserves and about 56 percent of the total gold and foreign exchange reserves of all countries outside the Soviet bloc. At the end of 1957, the last year in which the United States had a payments surplus, it held 61 percent of the gold and 42 percent of the gold and foreign exchange reserves of these countries. From 1958 to 1964, the U.S. share of total reserves decreased further to 37 percent of the gold and about 24 percent of the gold and foreign exchange reserves of all countries outside the Soviet bloc.

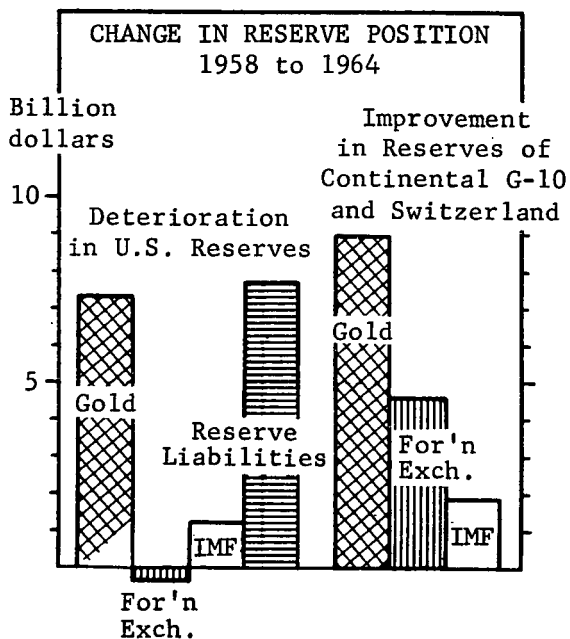
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The redistribution of monetary reserves, and particularly of gold, has been very uneven. Some important trading and financial centers, including the United Kingdom, have had little or no increase in reserves. On the other hand, the reserve position of the large industrial countries of continental Europe has improved about as much as that of the United States deteriorated. Their gold reserves increased more than those of the United States decreased, as they absorbed a major part of the newly mined gold and gold sales of the Soviet Union as well as most of the gold transfers from the United States. But their foreign exchange reserves, predominantly in dollars, increased considerably less than the rise in U.S. reserve liabilities. The redistribution of reserves reflects not only the great strength of the pay-

ments position of the large industrial countries of continental Europe, but the importance most of them attach to holding their reserves in gold.



It has been said that as a consequence of the U.S. deficit, the surplus countries have been compelled to accumulate unwanted reserves. If this implies that these countries now have a larger proportion of total monetary reserves than they have traditionally held in the past or more than they need, the statement is not true for some of the European countries. France and Germany now hold a smaller proportion of the total monetary gold stock than they did in 1914. And their gold and foreign exchange reserves at the end of 1964 were a far smaller proportion of total monetary reserves than they were 50 years ago. It is difficult to see how it can be said that the reserves of France and Germany are excessive in relation to their role in the world economy.

Italy and Belgium were moderately large holders of gold before World War I and their present gold reserves are not a significantly different proportion of the total monetary gold stock than they were then. At the end of 1964, Italy held 5.2 percent of the total monetary gold outside the Soviet bloc compared with 3.7 percent at the end of 1913. The gold reserves of Belgium at the end of 1964 were only 3.6 percent of the total monetary gold stock compared with 4.1 percent at the end of 1913. If allowance is made for their foreign exchange reserves, the proportion of total monetary reserves would be slightly higher for Italy and slightly lower for Belgium than for gold reserves alone.

The two countries with the largest proportionate increase in gold reserves are Switzerland and the Netherlands. In 1913, they had a

negligible part of the world monetary gold stock—only 1.3 percent of the total outside the present Soviet bloc. At the end of 1964, they held about 10.8 percent of the total gold reserves and about 7.9 percent of the total gold and foreign exchange reserves of all countries. As these figures indicate, Switzerland and the Netherlands are holders of gold rather than foreign exchange.

Japan, Canada, and Sweden hold their reserves predominantly in foreign exchange. Nevertheless, they now hold a somewhat larger proportion of total gold reserves than they did 50 years ago. At the end of 1913, Japan, Canada, and Sweden held about 2.4 percent of the total monetary gold stock outside the present Soviet bloc. At the end of 1964, their gold reserves were 3.7 percent of the world total. Their holdings of gold and foreign exchange reserves at the end of 1964, however, were a much larger proportion of total monetary reserves than they had been before World War I.

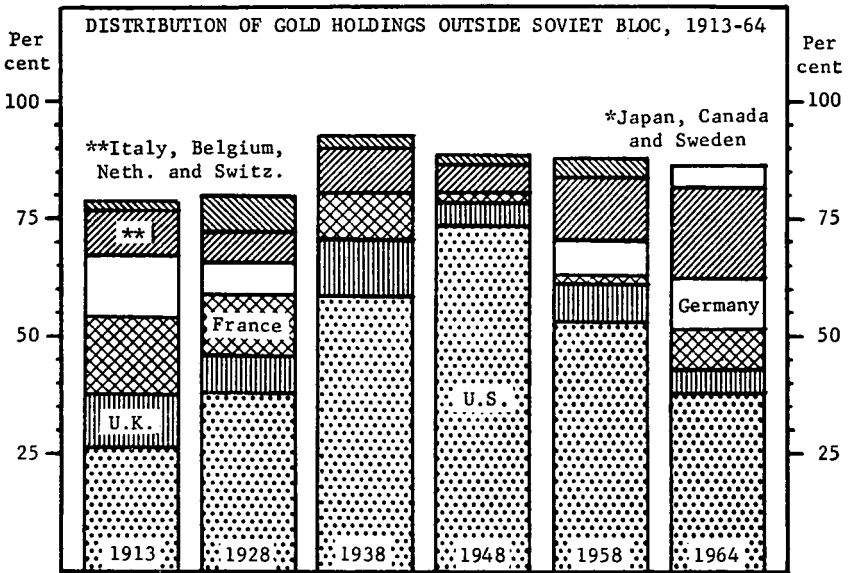
After allowance is made for the relatively small reserves of some of the largest countries, including the United Kingdom and the United States, it is reasonable to conclude that aggregate monetary reserves are adequate although not significantly in excess of the needs of the world economy. But the maintenance of the steady growth in aggregate monetary reserves in recent years has been possible only because of the prolonged deficit in the U.S. balance of payments. As a practical matter, the U.S. deficit, as measured by reserve transactions, has not really been as large as shown by the deficit published in the U.S. statistics. Furthermore, during the past 5 years over \$4 billion of the U.S. deficit was due to net payments on unrecorded transactions, a considerable part of which must have been the repatriation of undisclosed European funds held in the United States. Such capital movements into and out of the United States in the past 30 years have been mainly in response to changes in the economic and political environment in Europe. The United States can reasonably say that these undisclosed capital movements have exaggerated the U.S. surplus in the past and they have exaggerated the U.S. deficit in recent years.

Gold reserves of large industrial countries, yearend 1918-64

	Million dollars						Percent of world total					
	1913	1928	1938	1948	1958	1964	1913	1928	1938	1948	1958	1964
United States.....	1,905	3,746	14,512	24,300	20,583	15,471	26.4	38.4	59.4	73.8	54.1	37.9
United Kingdom.....	830	784	2,690	1,611	2,807	2,136	11.5	7.7	11.0	4.8	7.4	5.2
France.....	1,200	1,254	2,430	548	750	3,729	16.6	12.9	9.9	1.7	2.0	9.1
Germany.....	916	650	29		2,639	4,248	12.7	6.7	.1		7.0	10.4
Italy.....	266	266	193	96	1,086	2,107	3.7	2.7	.8	.3	2.9	5.2
Belgium.....	296	126	581	624	1,270	1,451	4.1	1.3	2.4	1.9	3.3	3.6
Netherlands.....	61	175	998	167	1,050	1,688	.8	1.8	4.0	.5	2.8	4.1
Switzerland.....	33	103	701	1,387	1,925	2,725	.5	1.1	2.9	4.2	5.0	6.7
Japan.....	3	541	164	3	54	304	0	5.6	.7	0	.1	.7
Canada.....	143	114	192	401	1,078	1,026	2.0	1.2	.8	1.2	2.8	2.5
Sweden.....	28	63	321	81	204	189	.4	.6	1.3	.2	.5	.5
Total.....	5,679	7,786	22,809	29,317	33,445	35,074	78.7	79.9	93.3	88.7	88.0	85.8
World ¹	7,228	9,745	24,444	33,065	38,030	40,870						

¹ World total excluding countries now outside the Soviet bloc.

Source: Report of the Director of the U.S. Mint, 1915; Banking and Monetary Statistics, Federal Reserve Board, 1943; International Financial Statistics, June 1965.



For the world as a whole, as distinguished from the surplus countries of continental Europe, the growth of reserves has actually been at a moderate rate in recent years. From 1958 to 1964, the gold and foreign exchange reserves of all countries outside the Soviet bloc increased by nearly \$10.5 billion, of which about \$3.5 billion was in gold. This is an average annual increase of 2.5 percent in the gold and foreign exchange reserves of all countries. In a sense, therefore, the U.S. deficit provided about the proper amount of foreign exchange reserves to supplement the growth of gold reserves. When the U.S. deficit is eliminated, the increase of monetary reserves will be limited to that part of the newly mined gold and gold sales of the Soviet Union which does not go into private hoards and industrial uses. As this has averaged about \$600 million a year, it would mean a growth of about 1 percent per annum in total monetary reserves for all countries outside the Soviet bloc. Clearly, it will be necessary to devise some other means of providing reserves to add to present holdings of gold and foreign exchange.

Methods of providing new reserves

There is widespread agreement that the present system of providing reserves should be placed on a more rational basis. There is some difference of opinion regarding the urgency of such a step, although clearly it cannot be delayed beyond the next year or two. The simplest method of dealing with the reserve problem would be to make greater use of the International Monetary Fund, enlarging its resources at a regular rate. In effect, the need for reserves would then be met by greater reliance on reserve credit from the Fund. For countries that cannot afford to hold adequate reserves of their own, which means virtually all of the underdeveloped countries, such a method of meet-

ing their reserve needs would be completely satisfactory. On the other hand, it is not feasible for the large industrial countries to depend too much on reserve credit. They need adequate reserves of their own, not only to meet their ordinary balance-of-payments deficits, but to finance short-term movements of liquid funds, and to convert balances of their currencies held by other countries. In fact, the reserve needs of the large industrial countries can be met only through the creation of new reserve assets that could be used with gold in international settlements.

It is sometimes said that the gold tranche is equivalent to a country's own reserves and that the large industrial countries can increase their own reserves through the maintenance of a creditor position in the Fund. Actually, the gold tranche is not precisely equivalent to a country's own reserves. Drawings on the gold tranche, although readily available to members, must be repaid in 3 to 5 years. But the supergold tranche, the net creditor position in excess of 25 percent of the quota, is fully equivalent to a country's own reserves. Unfortunately (the aggregate amount of the supergold tranche of the large industrial countries cannot be significant. This is because their supergold tranche is the counterpart of the net debtor position of all other members of the Fund. Unless these other countries are continually in debt to the Fund for large amounts—a practice wholly in contradiction to the use of the Fund as a revolving source of reserve credit—the aggregate supergold tranche of the large industrial countries will ordinarily be small. At the end of April 1965, the net drawings of the less-developed countries were less than \$1.4 billion and the net drawings of all countries, other than the large industrial countries, amounted to only \$1.5 billion. This indicates the limited character of the supergold tranche as a source of reserves for the large industrial countries.

If the Fund is to become a source of owned reserves, it would have to be through a radical change in its present structure and operations. Professor Triffin has proposed that the Fund be reorganized as a world central bank with the power to create reserves. The present system of quotas would be abolished and the Fund would instead create international monetary reserves through loans and open market operations, in much the same way as national central banks now create domestic money. Mr. Stamp has proposed that the Fund create a steady growth of reserves by acquiring the securities of the World Bank, thus at the same time providing this institution and its affiliates with loanable funds. The Fund staff is now supporting the view that the Fund should become a reserve-creating institution.

The creation of reserves by the Fund would be wholly at variance with the principles on which it was established. The two basic principles adopted at Bretton Woods are the passivity of the Fund and the limited obligation of a member to provide it with resources. Article V, section 2 of the Fund Agreement states:

Except as otherwise provided, operations on the account of the Fund shall be limited to transactions for the purpose of supplying a member on the initiative of such member, with the currency of another member in exchange for gold or for the currency of the member desiring to make the purchase.

The obligation of a member to provide resources to the Fund is limited to its quota subscription, although under Article VII, section 2 of the Fund may

require the member to sell its currency to the Fund for gold.

And it may

propose to the member that, on terms and conditions agreed between the Fund and the member, the latter lend its currency to the Fund * * * but no member shall be under any obligation to make such loans to the Fund * * *

These provisions are an absolute denial of power to the Fund to act as a world central bank. Nevertheless, it may be asked whether the time has come to amend the Fund agreement so that it could become a world central bank. Superficially, it seems reasonable to entrust a world central bank with the authority to create reserves in much the same way as national central banks create domestic money. The analogy, however, is fallacious. A national central bank can be empowered to create money because there is a consensus on an appropriate monetary policy. In the United States, differences of opinion on monetary policy involve fine distinctions as to whether there should be a greater or lesser degree of credit ease. In quantitative terms, the difference of opinion is infinitesimal. The total reserves held by all member banks of the Federal Reserve system is over \$21 billion. Most advocates of an easier credit policy mean that they would prefer to have these reserves about \$100 million to \$200 million larger than they are—a difference of one-half to 1 percent.

No such consensus is possible in the creation of monetary reserves by a world central bank. While the behavior of the economy is much the same in most regions and most sectors of a country, the behavior of the national economy may differ widely from country to country. Furthermore, the objectives of economic policy and the means of achieving them are completely different among countries. What may seem like a very moderate increase of monetary reserves to some less developed countries may seem like a wildly inflationary increase of monetary reserves to the industrial countries. And even among the industrial countries, there could be great differences of opinion from time to time on an appropriate policy for creating reserves, with surplus countries reluctant to see an increase in reserves and deficit countries eager for a substantial increase of reserves. Furthermore, no large industrial country could accept the obligation to accumulate reserve assets without limit when such reserves can be created by an institution comprising 102 members.

Practical considerations require that the creation of new reserves be limited to a predetermined annual amount, that these reserves be given an assured quality comparable to gold and dollars, and that they share with gold the characteristic of acting as the ultimate reserve asset. In order to meet these tests the creation of new reserve assets will have to be undertaken by a group of countries with similar needs, with similar monetary policies, and with a high degree of balance-of-payments discipline. Nevertheless, the method of creating reserve assets should be consistent with the maintenance of the role of the Fund as the central international monetary authority. Furthermore,

the Fund should participate in the creation of the reserve assets, with part of them assigned to the Fund to strengthen its liquidity and to enable it to perform more effectively its function as the principal source of reserve credit for its members.

Composite gold standard

The best way of assuring an adequate growth of monetary reserves is by having the Group of Ten and Switzerland establish a composite gold standard consisting of gold and currency reserve units for transactions with each other. A Reserve Unit would be equal to one U.S. gold dollar of the present weight and fineness, and it would consist of U.S. dollars, sterling, French francs, German marks, lire, guilders, Belgian francs, Canadian dollars, yen, Swedish kronor and Swiss francs in specified proportions. Each participating country would undertake to hold Reserve Units in an agreed ratio to its holdings of gold and to convert its currency at the request of participating countries into gold and Reserve Units in this ratio. Thus, Reserve Units would act jointly with gold as the ultimate reserve asset and they would be used together in international settlements among the participating countries.

The Reserve Units would be created by having the participating countries deposit their own currencies in a trust account with the International Monetary Fund. In return, these countries would be credited with an equivalent amount in Reserve Units. Thus, if the United States deposited \$400 million in U.S. dollars in the trust account, it would be credited with 400 million Reserve Units. And so with all other participating countries who would deposit proportionate amounts of their own currencies and would be credited with equivalent amounts in Reserve Units. In order to avoid a sudden and excessive increase in international liquidity, the creation of Reserve Units would take place gradually in predetermined amounts.

There are a number of questions that would have to be settled in order to establish a composite gold standard. One of the most difficult is the composition of the Reserve Unit—that is, the proportion of each national currency comprising the Reserve Unit. As this new reserve asset would be used jointly with gold in settlements among the participating countries, it should be composed of their currencies in proportions reflecting their relative use in international payments. The quotas in the Fund and the allotments under the General Arrangements To Borrow would seem to provide a reasonable basis for the composition of the Reserve Unit, although clearly neither the quotas nor the borrowing allotments reflect the greatly increased role of the continental European countries in the world economy. The difficulty could be solved if the countries in the Group of Ten would agree to have their quotas in the Fund and their allotments under the General Arrangements To Borrow increased to the same proportions as the currency composition of the Reserve Unit. Switzerland could make a comparable arrangement without becoming a member of the Fund.

Another difficult question is the ratio of gold to Reserve Units to be used in converting the currencies of the participating countries. The ratio should be high enough to maintain the disciplinary effect of gold in international settlements. It should not be so high, however, as to intensify the present sensitivity of the international monetary system

to gold. An appropriate ratio of gold to Reserve Units could be determined by the gold and foreign exchange holdings of the large industrial countries, excluding the United States. At present, this ratio is just under \$2 of gold to \$1 of foreign exchange. The adoption of this ratio for the composite gold standard would maintain the relative role of gold and foreign exchange in international settlements based on present monetary reserves, but the growth of monetary reserves in the future would depend on the creation of Reserve Units rather than on increments of dollars resulting from a U.S. payments deficit.

The adoption of the composite gold standard would involve a minimum change in the present international monetary system. Countries would be completely free to hold reserves in whatever form they wish. Many nonparticipating countries would continue to hold dollars and sterling as reserves because of the high return on such short-term investments, the liquidity of the New York and London money markets, and the ease with which such reserves can be used in foreign exchange operations. Even the participating countries could hold reserves in whatever form they wish, subject only to the requirement that if they hold reserves in gold they must match such holdings with Reserve Units in the prescribed proportion. All participating countries would, of course, be required to convert balances of their currency held by the monetary authorities of other participating countries in the ratio of two-thirds gold and one-third Reserve Units.

The composite gold standard could be established on an interim basis without any fundamental change in the present monetary arrangements. The participating countries—that is, the Group of Ten and Switzerland—could enter into an agreement to be effective for 5 years. During this period they would undertake to create a stated amount of Reserve Units each year, say about \$1 billion annually. A change in the amount of Reserve Units to be created in any one year, as fixed in the initial agreement, would be subject to unanimous consent. Before the expiration of 5 years, the participating countries would determine whether to place the agreement on a permanent basis.

There is one change that would be necessary under an interim agreement and even during a transition period under a permanent agreement. Obviously, during the early years of a composite gold standard, the participating countries would not be able to hold Reserve Units in the ratio of one Reserve Unit to \$2 of gold. This is because the creation of Reserve Units would be gradual and the amount created would not be large enough to support this ratio. Conversion of their currencies by the participating countries for each other should, nevertheless, be two-thirds in gold and one-third in Reserve Units. Thus, the Reserve Unit would assume immediately its function of sharing with gold the role of an ultimate reserve asset used in international settlements.

An agreement on the composite gold standard could retain a great deal of flexibility. It would be possible, for example, to permit any country to withdraw by giving reasonable notice. When a country withdraws, it would surrender its holdings of Reserve Units to the trustee and its claims would be met immediately to the extent that its national currency is held in the trust account. If the country is a net creditor, so that its holdings of Reserve Units exceed the amount

of its national currency in the trust account, the balance would be repaid in its own currency or in gold over a 5-year period. Similarly, if it is a net debtor, after offsetting holdings of its currency in the trust account, it would repay its obligation in gold over a 5-year period. This is the same provision as that in the Fund Agreement for settling accounts with a member that withdraws.

In much the same manner, provision could be made for adding another country to the participants in the composite gold standard. When and if it becomes desirable to enlarge the Group of Ten, the adhering member would be assigned a proportion of the Reserve Unit to be comprised of its currency. It would be possible then to increase to this extent the amount of Reserve Units created each year. Alternatively, the amount of Reserve Units to be created could remain the same, but the amount allotted to each original participant would be smaller until the trust account holds the appropriate proportion of the currency of the adhering member. The only change would be that the Reserve Unit would be comprised of 12 currencies instead of 11. All other aspects of the composite gold standard would remain the same.

As a recognition of the responsibility of the Fund as the central international monetary institution, and to enable it to function more effectively as a source of reserve credit for its 102 members, the Fund should have a positive role in the composite gold standard. Quite apart from acting as trustee for the national currencies in the Reserve Unit account and as depository for the participants' holdings of Reserve Units, the Fund should be a party to the agreement establishing the composite gold standard and it should be assigned a share in the Reserve Units that are created. For example, the Fund could be assigned a 25-percent participation in the Reserve Unit. If this were done, the Reserve Unit would consist of 75 cents in the currencies of the Group of Ten and Switzerland and 25 cents in notes of the Fund convertible into any currency held by the Fund, at the option of a participant, or in gold or the currency of the member requesting the conversion, at the option of the Fund. Such a claim on the Fund should be as acceptable backing for Reserve Units as the currencies of the participating members.

The participation of the Fund in the creation of Reserve Units would provide a substantial addition to its resources. For every \$1 billion of Reserve Units created, \$250 million would be allotted to the Fund. The Fund would be able to sell these Reserve Units to participating countries for their own currencies. Thus, the Fund could replenish its holdings of the currencies of the large trading countries, some of which are now far below the Fund's needs. The participation of the Fund in such a plan would greatly strengthen its liquidity and enable it to perform more effectively its role as the principal source of reserve credit. Furthermore, with 25 percent of the Reserve Units assigned to the Fund, and with these resources principally used for their benefit, the other members would be participating in the composite gold standard through the Fund on a larger proportionate scale than their own holdings of gold reserves or their role in international payments.

CHANGES IN THE INTERNATIONAL MONETARY SYSTEM

(By Edward M. Bernstein, October 27, 1964)

SUMMARY AND CONCLUSIONS

The present international monetary system is based on the provisions of the International Monetary Fund requiring its members to define their currencies in terms of gold and to maintain their foreign exchange value within 1 percent of parity. In order to maintain fixed parities, countries must have reserves to meet their payments deficits. At present the monetary reserves of all countries amount to over \$40 billion in gold and \$25 billion in foreign exchange. In addition, members of the Fund have access to reserve credit from that institution; and the large industrial countries have agreements with each other for currency swaps.

Although the present system has worked well, it is not a satisfactory method of providing reserves. From 1958 to 1963, a major part of the increase in the reserves of other countries came from the U.S. payments deficit. Some European countries feel that the financing of the U.S. deficit through the accumulation of dollar reserves tends to encourage inflation and to transmit it to other countries. In fact, the United States has been free of price and cost inflation in recent years. Despite the deficit, it has made a large net contribution to the resources of the rest of the world through its \$6.5 billion surplus on current account.

The magnitude of the U.S. payments deficit has been greatly exaggerated. Even properly defined, the deficit is not always a satisfactory measure of the U.S. payments position. One striking feature of the U.S. deficit from mid-1963 to mid-1964 is that very little of it was settled by a decrease of U.S. reserve assets or by an increase in reserve liabilities to foreign official institutions. The recent change in the U.S. balance of payments is indicative of an impending decline in the growth of monetary reserves. It will be necessary to find some other method of supplementing gold, dollars and other foreign exchange in order to assure adequate monetary reserves.

One feature of the present international monetary system is that all reserves are linked to gold as the ultimate reserve asset. The prospective growth of gold reserves is too small to enable it to function satisfactorily as the ultimate reserve asset. A larger part of the financing of international settlements will have to be in some other reserve asset used jointly with gold. This could be done by establishing a composite gold standard of gold and Reserve Units consisting of the currencies of the large industrial countries. The participating countries could undertake to hold Reserve Units in an agreed ratio to gold—say, \$2 of gold to \$1 of Reserve Units—and to convert their currencies for each other in this ratio.

The composite gold standard is intended to deal with a problem that is peculiar to the large industrial countries. Nevertheless, it may

be desirable to give the Fund a more positive role in the creation of Reserve Units by assigning to it 20 percent of the total. The Fund could sell the Reserve Units for the currencies of the participating countries. This would strengthen the Fund's liquidity and enable it to provide reserve credit on a larger scale and with greater assurance to its other members. In this way all countries could share in the benefits of the composite gold standard.

CHANGES IN THE INTERNATIONAL MONETARY SYSTEM

Fixed parities and reserves

The present international monetary system is based on the undertaking of the members of the International Monetary Fund to establish a fixed parity for their currencies in terms of gold and to maintain the foreign exchange value of their currencies within 1 percent of parity. This system of fixed exchange rates is a form of the gold standard. It differs from the classical gold standard, however, in the relative importance attached to fixed parities and to other objectives of economic policy. Under the gold standard, the maintenance of the gold value of the currencies was the principal if not the sole objective of economic policy. In the present system, the objectives of economic policy include not only the maintenance of the gold value of the currency, but stability of prices, a high level of production and employment, and sustained growth.

In order to maintain a system of fixed parities, countries must hold monetary reserves to meet deficits in their balance of payments. These reserves must be large enough to give them time to correct "maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." At the end of 1963, the monetary reserves of all countries, excluding the Communist bloc, amounted to over \$40 billion in gold and over \$25 billion in foreign exchange, mainly U.S. dollars and sterling. In addition to these reserves which countries hold for themselves, the International Monetary Fund has \$15 billion in gold and currencies to which the members of the Fund have access under stated conditions. Apart from these arrangements, the United States and other large industrial countries have agreements with each other (and with the Bank for International Settlements) for currency swaps which provide assured credits aggregating over \$4 billion.

This is the international monetary system we have now. It has worked very well. The evidence of this is the state of the world economy. The Second World War was infinitely more destructive than the First World War. Nevertheless, there was a quick and lasting recovery, and an enormous expansion of world trade and investment. The prosperity of the last 15 years is unparalleled in the history of the world. No doubt, there will be recessions from time to time that will temporarily interrupt economic growth, as there have been on a number of occasions from 1946 to 1960. We can be quite sure, however, that such recessions will not be permitted to generate into a worldwide depression. This is not to deny that there are dark spots in the world economy, particularly the failure of the underdeveloped countries to share fully in the postwar economic progress. The high-income countries, and particularly the large industrial countries, have a responsi-

bility for helping the underdeveloped countries to accelerate their economic growth and to raise their standard of living.

As the present international monetary system has worked so well, it may be asked why there is so much concern about it. The reason is that the forces that have permitted a steady growth in monetary reserves since 1950 cannot continue to operate in the same way in the future. The key to this is the position of the United States as a reserve center and the role of the dollar as a reserve currency. When the United States pays out more dollars than it receives in international trade and investment—that is, when it has a payments deficit—the excess is acquired by foreign central banks. While some of these dollars may be converted into gold, the rest are retained and added to the monetary reserves of the countries that hold them. From 1950 to 1958 an important part of the increase, and from 1958 to 1963 a major part of the increase in the monetary reserves of other countries came from the deficit in the U.S. balance of payments.

This is not a satisfactory method of providing for the steady growth of monetary reserves. From the point of view of the United States, it is not feasible to continue a large balance of payments deficit that decreases its reserve assets and increases its reserve liabilities. From the point of view of the surplus countries of Western Europe, a large U.S. payments deficit may require them to absorb reserves on a considerable scale at a time when their economies are short of productive resources. Most important, the world economy cannot rely on such an uncertain source of reserves. For at times the U.S. payments deficit may be too large, and at other times it may be too small to provide the foreign exchange supplement to gold necessary for an adequate but not excessive growth of monetary reserves. With the imminent restoration of the U.S. balance of payments, some new method of providing reserves to supplement gold, dollars and other foreign exchange will become essential in the near future.

The gold exchange standard and inflation

It is sometimes said that the great defect of the gold exchange standard is that the reserve centers are automatically able to finance large and prolonged deficits in their balance of payments, that this encourages them to neglect corrective measures, and that they tend to generate inflation in their own countries and to transmit inflation to other countries. According to this view, the gold exchange standard imports an inflationary bias to the world economy.

It is true that to some extent the deficit of a reserve center will be financed by an increase in the holdings of its currency by the monetary authorities of the surplus countries. It is a mistake to assume, however, that a reserve center is indifferent to a large increase in its monetary liabilities to central banks, particularly when this is not accompanied by an increase in its reserve assets. The United States is very conscious of its responsibility for maintaining the present gold value of the dollar and it is very much concerned about correcting its balance of payments. Quite properly, however, this country wants to restore its payments position without imposing severe measures that would impair domestic production and employment or restrict international trade and payments.

Nothing could be more fallacious than the view that the U.S. payments deficit is an indication of inflationary conditions. The large

U.S. deficit since 1958 is the result of complex forces arising from the postwar adjustment of international trade and payments, adjustments which may be coming to an end. Far from having an inflated demand, the United States has had unused capacity and unemployed labor all through this period. The money supply (demand deposits adjusted and currency in circulation) has increased at an annual rate of about 2.2 percent a year since the beginning of 1958. Wholesale prices are the same now as in 1958; and the rise in the cost of living is less than in any other large country. Wage rates in manufacturing have increased considerably less than the increase in productivity. This is not the behavior of a country troubled by inflation.

Despite its payments deficit, the United States has been making a large net contribution to the resources of the rest of the world. From mid-1963 to mid-1964, the surplus of the United States on goods and services was about \$7 billion, nearly \$2 billion of which was with Western Europe. The U.S. deficit arises from the fact that its foreign aid and private investment have exceeded the large surplus on current account. From 1960 to 1963, over \$3 billion of the U.S. deficit was accounted for by net payments on unrecorded transactions, by far the greater part of which must have been the repatriation of undisclosed European funds. Such capital movements into and out of the United States in the past 30 years have been in response to political and economic developments in Europe rather than here.

The payments surplus of Western Europe is to a large extent the counterpart of the deficit in this country. The growth of their reserves of gold and dollars has aggravated the difficulty the monetary authorities have had in restraining the expansion of credit. Nevertheless, the direct effects of the balance of payments on the monetary expansion of Western Europe have been greatly exaggerated. Three-fourths or more of the monetary expansion in the Common Market countries in 1963-64 represent the increase of domestic credit rather than gold and foreign exchange reserves. The fact is that the inflationary pressures in Western Europe come from a very high level of domestic expenditures and a rapid rise in wages rather than from the relatively modest payments surplus on goods and services.

*Monetary expansion in Common Market countries, 1963-64*¹

	Increase in foreign assets	Increase in domestic credit	Percent of expansion due to domestic credit
Belgium (billion francs).....	-6.70	28.30	131.0
France (billion francs).....	2.83	9.33	76.7
Germany (billion marks).....	3.40	26.90	88.8
Italy (billion lire).....	-491.00	2,035.00	131.5
Netherlands (billion guilders).....	-74	2.80	135.9

¹ End of June 1963 to end of June 1964 except Belgium for which data are compared from end of March 1963 to end of March 1964.

Source: International Financial Statistics, October 1964, pp. 52, 122, 126, 170, 206.

U.S. payments deficit

The magnitude of the U.S. payments deficit has been greatly exaggerated. The Commerce Department measures the deficit by the decrease in the U.S. reserve assets (gold and foreign exchange), the

change in the U.S. position in the International Monetary Fund, the increase in banking liabilities to foreign official institutions, foreign commercial banks, foreign companies and individuals, and receipts from certain special intergovernmental transactions. The most doubtful part of this definition is the treatment of liquid dollar assets of foreign commercial banks and foreign companies and individuals as if they were equivalent to reserve liabilities of the United States. The far larger claims of U.S. banks and U.S. companies and individuals on foreign governments and foreign banks are treated as U.S. capital invested abroad. No other country presents its international transactions in this form. It introduces a bias of several hundred million a year against the United States in its balance of payments.

Even properly defined, the payments deficit cannot of itself be a satisfactory measure of the payments position of the United States. It makes a great difference whether the deficit is accompanied by a large or small outflow of U.S. capital. Although foreign investment at this time puts pressure on the U.S. reserve position, it also strengthens the long-run payments position of the United States. Furthermore, it makes a great difference whether the U.S. deficit is accompanied by a surplus in countries that hold a large proportion of their reserves in gold or in countries that hold a large proportion of their reserves in U.S. dollars. The best proof that the U.S. payments position is much better than indicated by the deficit is the behavior of the reserve and related accounts of the United States in 1963-64. From mid-1963 to mid-1964, the U.S. payments deficit on ordinary transactions, as defined by the Commerce Department, amounted to \$1,740 million. This deficit is determined by changes in the following accounts:

	<i>Million dollars</i>
A. Decrease in principal reserve assets-----	474
Gold-----	207
Convertible currency holdings-----	¹ -56
Decline in net IMF position-----	323
B. Increase in short-term banking liabilities in U.S. dollars-----	364
Foreign official institutions-----	² -287
Foreign banks-----	341
Other foreigners-----	310
C. Increase in official holdings of U.S. Government bonds and notes-----	238
D. Increase in official holdings of nonmarketable U.S. securities-----	166
Payable in dollars-----	-31
Payable in foreign currencies-----	197
E. Increase in other short-term and liquid liabilities to foreigners-----	² -248
F. Receipts from special intergovernmental transactions-----	746
Prepayments of U.S. Government loans-----	352
Advances on military exports-----	394
G. Grand total, all settlement categories-----	1,740

¹ Increase.

² Decrease.

One striking feature of the composition of the settlement accounts is that the decrease in reserve assets in 1963-64 amounted to only \$474 million, of which \$323 million represented the change in the U.S. creditor position in the International Monetary Fund. Another feature is the relatively small increase of short-term and liquid liabilities to foreign official institutions, which amounted to only \$117 million in 1963-64. These developments show that the impact of the deficit on the reserve liquidity of the United States has greatly diminished in the past 15 months. They are the qualitative indications of the great improvement in the U.S. balance of payments.

Changes in U.S. reserve assets and liabilities, quarterly 1963-64

[Million dollars]

	Assets				Liabilities to official institutions			
	Gold	Foreign exchange	IMF gold tranche	Total	Short-term dollar claims	U.S. bonds and notes	Non-marketable securities	Total
1963:								
1st quarter.....	-111	33	46	-32	-191	73	290	172
2d quarter.....	-116	-6	-2	-124	604	163	329	1,096
3d quarter.....	-196	28	-59	-227	69	130	-85	114
4th quarter.....	-38	58	-15	5	45	51	149	245
1964:								
1st quarter.....	-46	228	-131	51	-452	53	-259	-658
2d quarter.....	73	-258	-118	-303	80	5	141	226
3d quarter.....	34	1 51	1 14	1 99	1 26	1 2	1 123	(151)

¹ To Aug. 31.

² To July 31.

Source: Treasury Bulletin.

Because the United States is a reserve center, it makes a great difference whether the increase in its banking and monetary liabilities is to countries that typically hold a large proportion of their reserves in gold or in dollars. In general, a large increase in the monetary reserves of gold-holding countries is likely to result in a drain on the reserve assets of the United States. In the 12-month period from mid-1963 to mid-1964, the increase in reserves was relatively moderate for the industrial countries (i.e., the Group of Ten and Switzerland) and relatively large for all other countries. As a consequence, U.S. short-term dollar liabilities to banks and official institutions in the large industrial countries fell by \$847 million while such liabilities to other countries rose by \$968 million.

Outlook for reserves

The U.S. payments deficit has been an important means of redistributing the world's holdings of reserves and, particularly since 1958, of increasing the aggregate level of reserves. At the end of 1949—that is, immediately after the devaluations—the United States held 73 percent of the gold reserves and 55 percent of the gold and foreign exchange reserves of all countries outside the Communist bloc. At the end of 1957—the last year in which the U.S. balance of payments was in surplus—the United States held 61 percent of the gold reserves and 35 percent of the gold and foreign exchange reserves of these countries. From 1958 to the end of 1963, the U.S. share of monetary reserves de-

creased further to 39 percent of the gold reserves and 24 percent of the gold and foreign exchange reserves.

At the end of 1949, the large industrial countries, excluding the United States, held 15 percent of the gold reserves and 17 percent of the gold and foreign exchange reserves of all countries outside the Communist bloc. At the end of 1957 they held 26 percent of the gold and 29 percent of the gold and foreign exchange reserves of these countries. And by the end of 1963 they held 47 percent of the gold and 45 percent of the gold and foreign exchange reserves. At present, most of the large industrial countries of Europe are very well supplied with monetary reserves—much better, relative to their needs, than the United States.

The role of the U.S. balance of payments in the growth of reserves was especially important from 1958 to 1963. In this 6-year period, the gold reserves of all countries outside the Communist bloc, but excluding the United States, increased by \$10.2 billion. Of this increase, \$7.3 billion (over 70 percent) came from the decrease in U.S. gold reserves. The importance of the U.S. payments deficit was even greater proportionately in the growth of foreign exchange reserves.

From 1958 to 1963, the foreign exchange reserves of all countries outside the Communist bloc, but excluding the United States, increased by nearly \$5.6 billion. In the same period, the increase in foreign official holdings of short-term banking claims in U.S. dollars in the United States increased by \$4.5 billion. It should be noted that other dollar assets held by foreign monetary authorities which may be treated as monetary reserves are not included in this total.

Changes in reserves and selected reserve liabilities, 1958-64

[Million U.S. dollars]

	All countries excluding United States, increase in reserves of—		United States	
	Gold	Exchange	Decrease in gold reserves increase (—)	Increase in short-term banking liabilities to foreign official institutions, decrease (—)
1958.....	3,000	105	2,275	748
1959.....	925	-625	1,075	489
1960.....	1,843	2,365	1,703	1,058
1961.....	1,687	564	857	681
1962.....	1,280	967	890	1,022
1963.....	1,426	2,227	462	522
1961:				
1.....	71	727	111	-196
2.....	276	361	116	632
3.....	361	402	196	41
4.....	718	237	38	45
1964:				
1.....	-164	-358	46	-438
2.....	412	378	-73	66

Source: "International Financial Statistics" 1964-65 Supplement and October 1964.

Despite the large increase in official holdings of dollars, the growth of total gold and foreign exchange reserves in recent years has not been excessive. From 1960 to 1963, the increase in the gold reserves of all countries outside the Communist bloc amounted to \$2.3 billion—

an average annual rise of 1.5 percent. In the same 4-year period, the increase in the gold and foreign exchange reserves of all countries outside the Communist bloc was \$8.7 billion—an average annual rise of 3.7 percent. Obviously, as much of the increase was due to the U.S. payments deficit, the restoration of the U.S. payments position will greatly reduce the growth of monetary reserves.

The change in the U.S. payments position since mid-1962 has already had a striking effect on the growth of monetary reserves. Although the increase in gold reserves was unusually large because of the gold sales of the Soviet Union, the increase in foreign exchange reserves was relatively small and none of the increase was in the form of official short-term dollar claims on the U.S. banking system or money market. Once the balance-of-payments deficit has been eliminated, a considerable part of the addition to monetary gold will go to replenish U.S. reserves, and the increment of foreign exchange reserves will be negligible in U.S. dollars and very small in other currencies. If monetary reserves are to grow in the future at a rate adequate for an expanding world economy, it will be necessary to find some other means of providing reserves to supplement gold, dollars, and other foreign exchange.

Composite gold standard

In part the need for additional reserves can be met by increasing the quotas of the countries that are members of the International Monetary Fund. For many countries, particularly those that cannot afford to invest real resources in holding reserves of their own, this is a satisfactory means of meeting their steadily growing need for reserve facilities. For the large industrial countries, it is not feasible to depend too heavily on reserve credits. These countries may have large and sudden movements of short-term funds which place great strain on their balance of payments. The United States and the United Kingdom are subject not only to such balance of payments pressures, but to the risks inherent in a reserve currency; that is, of large-scale conversion of their currencies into gold even when their own balance of payments is not in deficit.

One feature of the present international monetary system is that all monetary reserve assets are linked to gold and are intended to be convertible into gold, directly or indirectly. The growth of gold reserves in the future cannot be on a scale adequate to enable gold to perform its function as the ultimate reserve asset. This is a problem of special concern to the large industrial countries—the Group of Ten and Switzerland. At the end of June 1964, these countries held 86 percent of the total gold reserves of all countries outside the Communist bloc. Excluding the United States, the gold reserves of these countries increased by \$1.5 billion a year from 1958 to 1963. It is obviously impossible for these countries to continue to accumulate gold reserves on such a scale. Furthermore, it is becoming more difficult to depend so heavily on gold transfers in the settlement of international balances. Gold can best perform its function if a larger part of the work of financing international settlement is assumed by some other reserve asset, fully equivalent to gold and well suited to act with gold as the ultimate reserve asset.

The best way of assuring an adequate growth of monetary reserves and of moderating the excessive dependence on gold settlements is by

having the Group of Ten and Switzerland establish a composite standard of gold and currency reserve units for transactions with each other. A Reserve Unit would be equal to one U.S. gold dollar of the present weight and fineness and it would consist of U.S. dollars, sterling, French francs, marks, Canadian dollars, lire, guilders, yen, Swedish krone, Belgian francs, and Swiss francs in specified proportions. Each participating country would undertake to hold Reserve Units in an agreed ratio to its holdings of gold and to convert its currency at the request of participating countries into gold and Reserve Units in this ratio.

The Reserve Units would be created by having the participating countries deposit their own currencies with the International Monetary Fund acting as trustee. In return, they would be credited with an equivalent amount in Reserve Units. Thus, if the United States deposited \$500 million in U.S. dollars in the trust account administered by the Fund, it would be credited with \$500 million in Reserve Units. In order to avoid a sudden and excessive increase in liquidity, the creation of Reserve Units would take place gradually. In general, the basis for determining the amount of Reserve Units created would be the growth of reserves in other forms—gold and foreign exchange. The objective would be to secure a growth in aggregate reserves of about 4 percent a year. To the extent that the increase of reserves in the form of gold and foreign exchange falls short of this amount, Reserve Units could be created to make good the deficiency.

In previous papers, I proposed that convertibility of their currencies into gold and Reserve Units be undertaken at a ratio approximately that of the aggregate gold holdings to the aggregate Reserve Units of the participating countries. Thus, the initial ratio of gold to Reserve Units would have been very high; but as additional Reserve Units were created, the conversion ratio would have been gradually reduced until it reached some agreed definitive ratio—say, \$2 of gold to \$1 of Reserve Units. On further consideration, it seems to me that such an interim arrangement is needlessly complex and that it does not achieve one of the basic purposes of the composite gold standard which is to reduce the dependence of the large industrial countries on gold settlements in connection with their balance of payments. It should be possible to start with the definitive ratio at once. If a country with a large payments deficit exhausted its holdings of Reserve Units (and could not buy or borrow Reserve Units from other countries) it would have to convert its currency into gold (or the currency of the country converting the balances) until it acquired additional Reserve Units.

One of the critical questions regarding the composite gold standard is the ratio of gold to Reserve Units in converting the currencies of the participating countries. The ratio of gold should be high enough to maintain the disciplinary effect of gold as the ultimate reserve asset. It should not be so high, however, as to intensify the present sensitivity of the international monetary system to gold. An appropriate ratio of gold to Reserve Units could be determined by comparing the gold and the foreign exchange holdings of the large industrial countries, excluding the United States. At present this ratio is just \$2 of gold to \$1 of foreign exchange. The adoption of this ratio for the composite gold standard would enable monetary reserves to grow in their present proportion of gold and currencies

without depending on a deficit in the U.S. balance of payments to provide a steady increase of reserves in the form of dollars. Such a ratio of gold to Reserve Units would maintain the dominant position of gold in the reserves of the large industrial countries and it would retain the function of gold as the limiting factor compelling countries to restore their balance of payments.

The Fund and the composite gold standard

The proposal for a composite gold standard has been criticized because the Reserve Units would be based on the currencies of the large industrial countries because the Reserve Units would be distributed among them. It should be emphasized that the composite gold standard is intended to deal with a problem that is peculiar to the large industrial countries. It is their currencies which are widely used in international trade and payments. It is these countries which are exposed to the danger of large movements of liquid funds from one financial center to another and the massive conversion of their currencies into gold.

The special position of these currencies in international trade and payments is evident in the operations of the International Monetary Fund. Of the \$7.7 billion of currencies drawn on the Fund in the past 17 years, 99 percent has been in the currencies of the Group of Ten. The Fund is aware that its liquidity, its capacity to extend reserve credit to its members, depends essentially on its resources in the form of the currencies of the Group of Ten. That is why the Fund has entered into the special arrangements to borrow an aggregate of up to \$6 billion from these countries. The United States is aware that when there is pressure on the dollar, the problem can be met by using the currencies of the other large industrial countries. It has, therefore, made arrangements for reciprocal swaps of \$2 billion with the Group of Ten, Switzerland, and the Bank for International Settlements.

The Group of Ten and Switzerland have special responsibilities in maintaining the equivalence in the value of currencies with gold. They hold 86 percent of the monetary gold of all countries outside the Communist bloc. All of the gold sold by the Fund for currencies has been to these countries. The Group of Ten and Switzerland have undertaken to assure the orderliness of the London market for gold through the gold pool formed by them and operated for their joint account. The success of the composite gold standard will depend entirely on creating a reserve asset fully acceptable to these gold-holding countries as the equivalent of gold. The Reserve Unit consisting of their own currencies is such a reserve asset.

The establishment of the composite gold standard would facilitate the development of a complementary program for dealing with the reserve problems of other countries. Most of the underdeveloped countries do not hold large reserves of their own because they cannot afford to invest real resources in this form. What they need is better access to a larger pool of reserves held by the Fund. It would be desirable to make the first credit tranche available to members on the same assured basis as the gold tranche. Furthermore, the policy on compensatory financing of export fluctuations initiated by the Fund in February 1963 could be improved by making the maximum

amount 50 percent of the quota and by placing the compensatory credits entirely outside the present quota-tranche system. For nine-tenths of the 102 members of the Fund such measures to give them greater and more assured access to reserve credit would be far more valuable than participation in a composite gold standard of which they would in any case make very little if any use.

Nevertheless, it may be desirable to give the Fund a more positive role in the composite gold standard than merely that of a trustee holding the national currencies in the Reserve Unit account and transferring the Reserve Units on its books. The participation of the Fund in the composite gold standard could be very helpful in providing the Fund with additional resources that would strengthen its liquidity and enable it to provide greater reserve credit to its members. This could be done by assigning the Fund a 20-percent participation in the Reserve Unit account. Thus, the Reserve Unit could consist of 80 cents in the currencies of the Group of Ten and Switzerland and 20 cents in notes of the Fund convertible into any currency held by the Fund or, at the option of the Fund, in gold or the currency of the member requesting the conversion. Such a claim on the Fund should be as acceptable as the currencies of the participating members.

The participation of the Fund in the creation of Reserve Units would provide a substantial addition to its resources. For every \$1 billion of Reserve Units created, \$200 million would be for the account of the Fund. The Fund would be able to sell these Reserve Units to participating countries for their own currencies, arrangements being made to assure an equitable allocation of the Reserve Units sold by the Fund among the participating countries. Thus, the Fund could replenish its holdings of the currencies of the large trading countries, some of which are now less than 50 percent of their respective quotas. The participation of the Fund in such a plan would greatly strengthen its liquidity and enable it to perform more effectively its role as the principal source of reserve credit. Furthermore, with 20 percent of the Reserve Units assigned to the Fund, and with these resources principally used for their benefit, the other members would be participating in the composite gold standard through the Fund on a larger proportionate scale than their own holdings of gold reserves.

National interests and the composite gold standard

The composite gold standard is not designed to bring about a fundamental change in the present international monetary system based on gold, foreign exchange, and the resources of the International Monetary Fund. One purpose is to provide an acceptable means of increasing reserves in the form of currencies when the U.S. balance of payments deficit is eliminated and the growth of official holdings of dollars becomes small or negligible. Another purpose is to diminish the excessive dependence on gold as the ultimate reserve asset—that is, the asset into which national currencies are convertible—by providing an acceptable reserve asset, in the form of Reserve Units, that will be equivalent to gold and that can be used in conjunction with gold as the basis for the composite gold standard.

The role of the dollar under such a system would not be inferior to what it is now. For many countries, the dollar is a more attractive reserve asset than gold because it can be held as a money market asset

yielding over 3.5 percent and it can be used to make payments anywhere in the world. There is no reason for thinking that a dollar that competes successfully with gold will have more difficulty in competing with Reserve Units. The United States has no desire to continue the balance of payments deficit even if it could be financed by the accumulation of dollar reserves by the surplus countries. It is not in the interest of the United States to have foreign official holdings of U.S. dollars increase at a rate that exceeds the increase in its own reserves.

There is a danger that the negotiations for creating new reserve assets will be hampered by an exaggerated concern with what are assumed to be national interests. There is no field in which the common interest is so largely relative to the purely national interest as in the world payments system. The view that the United States will continue to have a large payments deficit, properly defined, is as mistaken as the view that all of the Common Market countries will continue to have a large payments surplus. The arrangements for strengthening the international monetary system should proceed on the assumption that the large industrial countries can and will succeed in maintaining a strong balance of payments. The United States has the same interest as other countries in establishing a well-balanced pattern of international payments. It has the same interest as other countries in providing for the orderly growth of monetary reserves in an acceptable form and at a rate adequate to meet the needs of an expanding world economy.

TWO REPORTS ON INTERNATIONAL LIQUIDITY

(By Edward M. Bernstein, August 19, 1964)

SUMMARY AND CONCLUSIONS

The reports on international liquidity recently issued by the 10 large industrial countries and by the International Monetary Fund are the most important official statements on the international monetary system since Bretton Woods. The present international monetary system has worked well, although the Group of Ten is particularly concerned to see that a proper blend of economic policies is used by countries to secure a faster adjustment of payments imbalance while achieving essential internal objectives. The Group of Ten has suggested that the Organization for Economic Co-operation and Development undertake such a study. To improve international cooperation on liquidity problems the Group of Ten has decided that bilateral short-term credit facilities be kept under surveillance and review and the Bank for International Settlements will be asked to compile statistical data bearing on the means used to finance surpluses or deficits.

The two reports agree that there is at present adequate international liquidity. The real problem is regarding the growth of monetary reserves in the future. The Fund estimates that in the past 10 years reserve assets, such as gold, foreign exchange, and the gold tranche of members of the Fund, have increased at an average annual rate of 2.8 percent. If account is taken of Fund quotas and other reserve credit facilities, the growth of international liquidity in all forms averaged 3.3 percent a year. The growth of reserves in the future is unlikely to match the needs of the world economy. Although gold reserves may increase at 2 or 2½ percent a year, the growth of foreign exchange reserves may be at a slower rate as the U.S. balance of payments is further strengthened.

The Fund occupies a central position in the supply of international liquidity. In 1959 quotas were increased by 50 percent. Since then, there has been a large expansion of trade and payments. An increase of 25 percent in quotas would match the increase in the trade of most countries. A larger increase could be justified for some countries as a means of strengthening the liquidity of the Fund or as a reflection of their larger role in the world economy. The Fund should liberalize its policy by giving countries assured access to the first credit tranche of the quota. The Fund should also extend compensatory credits up to a normal maximum of 50 percent of the quota and place such credits completely outside the framework of the gold and credit tranches.

The Group of Ten states that "gold will continue to be the ultimate international reserve asset." Gold will not be able to perform this function if the supply of monetary gold is too small. The burden on gold can be reduced by supplementing it with a new type of reserve asset such as the Reserve Unit which would be composed of the currencies of the Group of Ten and Switzerland. The large industrial

countries would hold such Reserve Units in an agreed ratio to their gold reserves. This would raise by one-third the amount of monetary reserves that could serve as the ultimate international reserve asset. The Group of Ten has appointed a Study Group to assemble material for evaluation of this and other proposals for creating reserve assets. The two reports provide the basis for a practical program for meeting international liquidity needs through evolution of the present international monetary system.

TWO REPORTS ON INTERNATIONAL LIQUIDITY ¹

International monetary cooperation

At the annual meeting of the Board of Governors of the International Monetary Fund in 1963, the Group of Ten countries participating in the General Arrangements To Borrow agreed to study the functioning of the international monetary system and probable needs for liquidity. At the same meeting, the Managing Director of the Fund stated that it would intensify its studies of international liquidity with special emphasis on its role in providing monetary reserves. These reports have now been published. They are the most important official statements on the international monetary system since Bretton Woods. They accept responsibility for an adequate growth of international liquidity, and they recognize that this may require the creation of new types of reserve assets.

The Group of Ten says that the present international monetary system based on fixed exchange rates and the established price of gold has proved its value as a foundation on which to build for the future. The success in meeting the difficult economic problems after the Second World War is noteworthy when contrasted with the unfortunate experience with similar problems after the First World War. One reason for this is the very close cooperation among monetary authorities which began at Bretton Woods and has been greatly broadened since then. A second reason is that the international monetary system, although still based on fixed exchange rates and the established price of gold, is not the same as that which prevailed after the First World War.

The report of the Group of Ten states this clearly.

The objectives of economic policy in a free society are broad and complex. They include healthy and sustainable economic growth, full and efficient employment, together with goals in the field of social development, defense policy, and foreign aid.

These objectives need not be in conflict with the maintenance of stability of prices and equilibrium in the balance of payments. In order to avoid harsh restrictive measures, countries must prevent large and persistent payments imbalance and must act promptly to correct such tendencies when they occur. The report of the Fund also takes note of the importance of prompt corrective action.

¹ Ministerial Statement of the Group of Ten and Annex Prepared by Deputies, an "examination of the outlook for the functioning of the international monetary system and of its probable future needs for liquidity." The study was made by Deputies representing the Ministers of Finance and the Governors of the Central Banks of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. They invited the participation of representatives of the National Bank of Switzerland, the International Monetary Fund, the Organization for Economic Cooperation and Development, and the Bank for International Settlements. The study of the International Monetary Fund constitutes chs. III and IV of the 1963-64 annual report of that institution. Ch. III is entitled "International Liquidity: The Issues," and ch. IV is entitled "The Fund and International Liquidity."

Under the classical gold standard, adjustments to the balance of payments were made by both deficit and surplus countries. The monetary contraction induced by the outflow of gold in deficit countries had its counterpart in the monetary expansion induced by the inflow of gold in surplus countries. Although the balance of payments still acts on the monetary system in much the same way as under the classical gold standard, countries are more inclined now to take measures that insulate the domestic economy from the balance of payments. Furthermore, measures taken purely for domestic purposes, for example, a tightening of credit, may have considerable effect on the balance of payments of other countries through the impact on capital movements.

The report of the Group of Ten notes that it is necessary to combine budgetary and fiscal policies, income policies, monetary policies, and other measures to secure a mix appropriate to both internal and external objectives. This is so important to the functioning of the international monetary system that the Deputies have suggested that Working Party Three of the OECD, which has had experience in this field—

might be invited to study how member countries, individually and collectively, and compatibly with the pursuit of their essential internal objectives, could in the future preserve a better balance-of-payments equilibrium and achieve a faster and more effective adjustment of imbalance * * *. These studies would explore whether standards could be formulated on the contribution of monetary and related policies to balance-of-payments equilibrium against which the performance of countries could be appraised.

The purpose should be to secure a higher degree of coordination of policies among the Group of Ten in order to facilitate prompt adjustment of the balance of payments without adverse effects on the domestic economy.

In the past few years, an extensive system of bilateral short-term credit facilities has been developed to supplement the use of reserves and resources from the Fund in helping countries meet balance of payments deficits. These facilities include a network of swap arrangements designed to compensate short-term swings in the balance of payments. At the end of 1963, these reciprocal arrangements provided aggregate credit facilities amounting to about \$3.5 billion. The United States is the principal participant in these arrangements. Bilateral credit facilities have also been arranged from time to time in Basle on an *ad hoc* basis. On a number of occasions when there were sudden pressures on the balance of payments of a country, particularly because of capital movements, central banks have provided reserve credit to maintain orderly exchange markets. The United Kingdom has made use of these Basle credits because they could be arranged speedily and informally.

Central banks have also secured reserve credits, directly and indirectly, from nonofficial sources. The growth of the Euro-currency market has broadened the facilities available to commercial banks for borrowing abroad to offset a tightening of credit at home. When a central bank adopts a tighter credit policy for balance of payments reasons, the Euro-currency credits secured by its commercial banks have the effect of lessening the drain on its reserves. In a sense, therefore, international loans to commercial banks are a form of reserve credit.

The bilateral credit facilities have become an important adjunct to international liquidity. In order to improve international cooperation on liquidity problems, the Group of Ten has decided that it would be helpful to keep under surveillance and review the various elements in international liquidity. To do this, the countries in the Group will provide the Bank for International Settlements (BIS) statistical data bearing on the means used to finance surpluses or deficits in their balance of payments. These data, combined by the BIS, would be supplied confidentially to all participants and to Working Party Three of OECD. Information would also be exchanged among central bank governors on undertakings for new or enlarged credit facilities. The object would be to avoid "excesses or shortages in the means of financing existing or anticipated surpluses and deficits in the balance of payments" and to afford the monetary authorities "a better basis for strengthening their policy cooperation in the international monetary sphere."

Adequacy of monetary reserves

The Deputies of the Group of Ten regard international liquidity as consisting of a broad range of reserve assets of a primary and secondary character and of various credit facilities, some assured and some subject to negotiation. The reserve assets consist of gold and foreign exchange, as well as other assets such as the gold tranche in the Fund, holdings of special U.S. Treasury bonds, and swaps used by a partner country. The credit facilities include assured credits, such as unactivated swaps and Fund standbys, and credits subject to negotiation such as other Fund tranches and potential credit lines which cannot be estimated at all. At the end of 1963, the grand total of official reserves and credit facilities amounted to \$87.4 billion.

Official reserves and credit facilities, all countries, 1959 and 1963

[Billion U.S. dollars]

	End of 1959	End of 1963
Reserves.....	60.23	70.21
Gold and foreign exchange.....	56.98	65.27
Gold.....	37.88	40.20
Foreign exchange.....	19.10	25.07
Other reserve assets.....	3.25	4.94
IMF gold tranche.....	3.25	3.94
Special U.S. bonds.....		.71
Swaps used by other party.....		.29
Miscellaneous.....	(¹)	(¹)
Credit facilities.....	12.90	17.15
Assured credit.....	0.	3.67
Swaps unactivated.....		3.16
IMF standbys.....		.51
Other credit lines.....	(¹)	(¹)
Subject to negotiation.....	12.90	13.48
Other IMF tranches.....	12.90	13.48
Potential credit lines.....	(¹)	(¹)
Grand total, official reserves and credit facilities.....	73.13	87.36

¹ Not available.

This is an impressive total of resources available for meeting balance-of-payments deficits. There is, of course, an important difference between reserve assets and credit facilities, particularly those subject to negotiation. On the other hand, the table does not set out fully the credits that could be mobilized if they were needed. The Basle facilities do not lend themselves to quantitative inclusion in potential credit lines. Furthermore, the potential credit facilities should also include the borrowing arrangements of the Fund with the Group of Ten (to a total of \$6 billion) and the complementary arrangements of Switzerland with these countries (for \$200 million) which could provide additional resources under certain conditions.

There is no simple measure of the adequacy of reserves. The difficulty of making such a determination is especially great because of the large differences in reserves among countries, among the industrial countries as well as the developing countries. Reserves may be regarded as adequate if countries willing to invest resources in this form can acquire and hold sufficient reserves to give them time to make any necessary adjustments to correct a persistent payments deficit without being under pressure to impose unusually restrictive measures merely because they act quickly. On the other hand, reserves may be regarded as excessive if many countries can succeed in meeting balance-of-payments deficits for extended periods without being under pressure to take corrective measures. In assessing the adequacy of reserves, credit facilities should be regarded as a supplement to reserves. These are not easy tests to apply. What seems like adequate international liquidity to surplus countries, disturbed by the expansionary effect of their balance of payments, may seem like inadequate liquidity to deficit countries, disturbed by the need to restrain the economy in order to restore their balance of payments.

On the question of the adequacy of the present level of monetary reserves, the Group of Ten concludes that "for the international monetary system as a whole, supplies of gold and reserve currencies are fully adequate for the present," particularly as they are supplemented by a broad range of credit facilities. The Fund report agrees that the studies of the past year support the view that international liquidity is adequate at present. It notes, however, that "the conclusion that the general level of international liquidity is broadly satisfactory does not mean that its distribution among countries or the supply of each type of liquidity is equally satisfactory."

The real problem is whether the growth of monetary reserves in the future will be adequate for prospective needs. The Fund report states that "over the last 10 years the average rate of growth of gold reserves has amounted to 1.6 percent per annum, that of foreign exchange reserves to 4.3 percent per annum, and that of gold tranche positions in the Fund to 7.6 percent per annum. The average annual rate of growth of these three items combined has amounted to 2.8 percent per annum." In addition to these reserves owned by countries, resources are available through the credit tranches in the Fund, the swaps, and various *ad hoc* facilities such as the Basle credits. Taking into account such arrangements, as well as reserves owned by national monetary authorities, the Fund concludes that the average annual rate of growth of international liquidity in all forms over the past 10 years amounted to 3.3 percent.

The need for international liquidity will increase with the growth of world trade and payments, international investment and capital movements. This is not because payments difficulties are likely to prove more intractable in the future or because governments will be more tolerant of persistent deficits than in the past. It is simply a reflection of the greater volume of trade and investment and the greater freedom of capital movements. The growth of reserves, however, is unlikely to be on a scale to match the needs of the world economy—say, about 4 percent a year. The growth of the monetary gold stock may be somewhat greater than in the past decade, but it is unlikely to be at a rate of more than 2 or 2½ percent per annum. The growth in official holdings of dollars is likely to slow down as the U.S. balance of payments is further strengthened. An increase in the gold tranche of the Fund is not of significance as an additional factor in the growth of independent reserves unless some means is found of minimizing the gold payment in connection with further increases in Fund quotas.

Although the Group of Ten recognizes that there will be a need for greater liquidity in the future, they are of the opinion that this can be done within the present institutional arrangements. The Fund report emphasizes that the best means of providing increased liquidity is through an increase in Fund quotas and through more assured access by members to these quotas. The Group of Ten recognizes that there is a present need for an increase in Fund quotas and that in the longer run there may be a need for some new form of reserve asset.

Fund quotas and reserves

The International Monetary Fund occupies a central position in the supply of liquidity. The gold tranche of a member's quota (equal to the difference between the Fund's holdings of its currency and its quota) is equivalent to reserves. A country has complete assurance that it can draw on the gold tranche to meet a payments deficit. Drawings on the credit tranches of the quota are conditional on a member's taking measures to deal with its payments problem and the standards become more rigorous with each successive credit tranche of 25 percent of the quota. The Fund has arrangements by which a member can enter into a standby agreement to draw a stated amount of resources within an agreed period. Standbys are, in fact, assured reserve credits. Drawings on the Fund must be repaid when the reserves of a member increase and exceed its quota and in any case within a period of 3 to 5 years.

Although drawings on the Fund in successive credit tranches are conditional on the policies followed by members, the quotas are an essential part of the facilities available for meeting balance-of-payments deficits, particularly for countries with limited reserves of their own. The total quotas of all members of the Fund amount to about \$15 billion. The last general review of quotas was made in 1959 when the quotas of nearly all countries were increased by 50 percent. The next quinquennial review of quotas is scheduled for 1965. The Ministers and Governors of the Group of Ten have stated that—

they will support a moderate general increase in member quotas * * * [and] they will support relative adjustments of those individual quotas which are clearly out of line.

If the Fund is to provide about the same degree of liquidity for its members in the future as in the past, quotas will have to be increased with the growth of international trade and payments. There was a large increase in world trade between 1958 and 1963. In the industrial countries of continental Europe and Japan, the increase in trade was 66 percent for exports and 73 percent for imports. In the United States, the United Kingdom, and Canada, the increase in trade was 28 percent for exports and 26 percent for imports. In the less-developed countries, the increase in trade was 30 percent for exports and 17 percent for imports. Except for the industrial countries of continental Europe and Japan, an increase of 25 percent in quotas would about match the increase in the trade and payments of all other countries during the past 5 years.

For some of the industrial countries of continental Europe and Japan, a larger increase in quotas could be justified on the grounds that their relative role in the world economy has greatly increased in the past 5 years. This has a dual significance. Some of these countries (and others as well) may have a greater need for using the resources of the Fund and would for this reason prefer to have larger quotas. The Fund, in turn, may have greater need of the currencies of some of the industrial countries in order to meet the drawings of other members. For such countries, therefore, an increase in the quotas in excess of the general revision is desirable to strengthen the liquidity of the Fund.

The Fund Agreement provides that each country that consents to an increase of its quota shall pay 25 percent of the increase in gold and the balance in its own currency. However, if the monetary reserves of a member are less than its new quota, the Fund may reduce the gold payment. For most countries, the decrease of their own reserves of gold or foreign exchange arising from the gold subscription to the Fund will be offset by the increase in their gold tranche. The United States and the United Kingdom, however, will be called on to convert dollars and sterling to enable countries holding such reserve assets to pay their gold subscription to the Fund. For these reserve currency countries, an increase in quotas will result in a decrease in their own reserves, unless some method is found for avoiding the payment in gold.

The proposed revision of quotas will supply the Fund with considerable amounts of the currencies of the surplus countries so that it will not need additional gold for liquidity purposes. At present, the Fund holds nearly \$2.4 billion in gold apart from \$800 million in its gold investment account. Furthermore, the Fund has small but steady receipts of gold from its charges and from repurchases. The Fund should have no difficulty in acquiring moderate amounts of any currencies by using the gold it normally acquires and by drawing on some of its present holdings.

The Group of Ten has recommended that attention should be given to methods of minimizing the impact of transfers of gold from national reserves to the Fund. The Fund report notes various methods by which this could be done. One method suggested would be for the Fund to accept payment of the gold portion of the increase in quotas in the form of non-interest-bearing gold notes. These gold

notes would be redeemable in national currency so that when the Fund has need of a member's currency it would redeem the gold notes of that member. If the Fund should ever have a need for gold, it would be able to make a uniform percentage call on all countries for redemption of their gold notes, giving adequate notice of such a call. Alternatively, the Fund could invest in each country an amount equal to its gold subscription taking the member's special investment notes convertible into gold. These special investment notes would be redeemable in national currency at the request of the Fund. They would also be subject to redemption in gold, if necessary, after adequate notice of a uniform percentage call. Either method of paying the gold subscription would increase the member's gold tranche without drawing down its own reserves.

One further point should be noted on the resources of the Fund. In 1961-62, the Group of Ten countries undertook to lend the Fund their currencies to a total of \$6 billion under certain conditions. The purpose of these General Arrangements to Borrow was to enable the Fund to mobilize additional resources to deal with any threat to the international monetary system. The Government of Switzerland has entered into complementary arrangements to provide up to \$200 million to these countries for the same purpose. The General Arrangements To Borrow expire in October 1966 and a decision on renewal or modification must be taken not later than October 1965. The need for these emergency resources will not be met by the general increase in quotas. The Group of Ten should renew the Arrangements and, if possible, for a larger amount.

Fund policies on drawings

The Fund report notes various ways in which it could play a more important role in the provision of monetary reserves. Some of these methods involve no departure from existing practices and would necessitate no more than a liberalization of the present policies on drawings. Others would involve investment by the Fund through the acquisition of securities or other assets. Such investments might be made in currencies or in gold, on an equal basis with all members or on a selective basis, or perhaps in the securities of international institutions. The distinctive feature of investment operations is that they could be undertaken on the initiative of the Fund and they could be used to create reserves.

This would involve a basic departure from the principle of passivity of the Fund. Article V, section 2 of the Fund Agreement states that—

operations on the account of the Fund shall be limited to transaction for the purpose of supplying a member, on the initiative of such member, with the currency of another member in exchange for gold or for the currency of the member desiring to make the purchase.

The passivity of the Fund is not an expression of a narrow doctrinal view. It is a recognition, to quote the Fund report, that—

the determination as to whether the available supply of liquidity is adequate or inadequate must always be a matter of judgment, and a collective judgment is particularly difficult to arrive at because the balance of advantage, at any rate in the short run, may be different with respect to, and in the opinion of, different countries.

The Fund agreement avoids this difficulty in a commonsense way. By agreeing in advance to drawing rights based on prescribed quotas and by agreeing in advance to a prescribed subscription of resources, the rights and obligations of debtor and creditor countries are fixed at an acceptable level. Because these rights and obligations are limited, it is possible to give the Fund the power to provide reserve credit to its members out of the resources at its disposal. A system that entrusted the Fund with the power to create reserve credit at will, and on a large scale, would have to be circumscribed by onerous disciplinary requirements governing the creation and granting of such credits. Between an institution with virtually unlimited resources using very strong disciplinary powers and an institution with more moderate resources using considerable advisory powers, the needs of the world economy are better served by the latter. That is the kind of institution the Fund is and the kind it should remain.

Nevertheless, the Fund can do much more in providing international liquidity. It is entirely within the power of the Fund to liberalize the conditions under which its members may draw on their quotas. As a minimum, the Fund should make the first credit tranche as freely available to its members as the gold tranche is at present. This was the understanding in all of the preliminary discussions prior to Bretton Woods, as the minutes of these meetings clearly show. The experience of the Fund with drawings and repurchases is far better than could have been envisaged 20 years ago. The Fund can safely modify its policy and give members complete assurance that they will be permitted to draw the first credit tranche of their quotas.

The Fund report does not discuss its policy on compensatory credits. This is unfortunate, for the report recognizes that the reserves of primary producing countries, taken as a group, tend to remain small because of their urgent need for imports. These countries have a greater deficiency of reserves relative to needs than other members of the Fund. The Fund policy of February 1963, on compensatory financing of export fluctuations, was a recognition of the reserve problems confronting these countries. That policy assures them that when there is a temporary shortfall of exports attributable to circumstances beyond the control of a member, and when the member cooperates with the Fund in an effort to solve its payments difficulties, the country can count on compensatory drawings that will not normally exceed 25 percent of its quota.

There have been very few drawings under this provision, largely because of the recent improvement in prices of primary products. Nevertheless, cyclical fluctuations in exports of primary products will recur. If the decline in prices of basic commodities were to be moderately large or if the decline were to continue for 2 years, compensatory credits of 25 percent of the quota would not be enough to meet the payments difficulties of the exporting countries. The United Nations Conference on Trade and Investment has adopted a resolution requesting the Fund to study two modifications of its present policy on compensatory credits. The first is to increase to 50 percent of a member's quota the maximum amount of compensatory drawings that would normally be allowed to be outstanding. The second is to place compensatory credits entirely outside the structure of the gold and credit tranches, so that the drawing of compensatory credits would

not directly or indirectly prejudice a member's ability to make an ordinary drawing. These are constructive changes in the policy on compensatory credits that the Fund should promptly adopt.

Creation of new reserve assets

The two reports agree that the growth of gold and foreign exchange reserves is not likely to meet the needs for greater liquidity in the future. Gold production will continue to rise, gold sales of the Soviet Union may remain large, and it may be possible to channel more of the new supply of gold into official reserves. Even so, the Fund report concludes that the increase of monetary gold holdings will not exceed 2 to 2½ percent a year. The U.S. balance of payments has been improving and the contribution of dollar holdings to international reserves is unlikely to be on the same scale as in the past. In the view of the Deputies, "there is no immediate prospect of any other currency assuming the function of an international reserve currency. Indeed, at the present juncture," they say, "such a development could raise problems without substantially strengthening the system."

Under the circumstances, there appears to be no way by which monetary reserves in the form of gold and foreign exchange can grow at a satisfactory rate. There can, of course, be an increase in Fund quotas and an expansion of reciprocal credit facilities. Nevertheless, it is not a matter of indifference whether the increase in monetary reserves is predominantly in the form of gold and foreign exchange assets or predominantly in the form of Fund quotas and reciprocal credit facilities. Countries that can afford to hold reserves should not be too dependent on contingent credit facilities to meet balance of payments deficits. In fact, some deputies have suggested that there may be exceptional cases where longer term loans within the Group of Ten might be desirable in order to strengthen the reserve position of some low reserve countries.

The report of the Group of Ten states that "gold will continue to be the ultimate international reserve asset." Unfortunately, gold cannot function as the ultimate reserve asset if the amount of monetary gold is too small for this purpose. Of the increase of reserves and credit facilities of all countries in the 4 years ended in 1963, gold provided less than one-sixth (\$2.32 billion out of \$14.23 billion). While the growth of other reserve assets and credit facilities has helped to meet the need for international liquidity, the increase of gold reserves has not been sufficient to satisfy the preference of the large industrial countries for holding reserves in this form. As a consequence there is a serious danger of a competitive effort to accumulate more gold by the Group of Ten and Switzerland than can be met out of the normal increment of monetary gold.

Although the stock of monetary gold cannot be increased significantly, there is a way of reducing the burden on gold as the ultimate international reserve asset. This can be done by supplementing gold with a new type of reserve asset whose supply is not affected by the balance of payments or the monetary policy of any one country, the two serving together in fixed proportions as the ultimate international reserve asset. Such a new type of reserve asset, denominated as a Reserve Unit equivalent to \$1 in gold, could be composed of the national currencies of the Group of Ten and Switzerland in prescribed pro-

portions. The large industrial countries would undertake to hold such Reserve Units in an agreed ratio to their gold reserves (say, one Reserve Unit for each \$3 of gold) and to make their national currencies convertible into gold and Reserve Units in this ratio. This would have the effect of raising by one-third the amount of monetary reserves serving as the ultimate international reserve asset.

A composite standard of gold and Reserve Units would involve no fundamental change in the present international monetary system. The Reserve Unit is not intended to displace the use of the dollar in international trade or payments, or the holding of dollar assets as liquid investments or as monetary reserves. Nor is the Reserve Unit intended to diminish in any way the role of the Fund in providing reserves and reserve credits through the quotas of its members. The strength and flexibility of the international monetary system would, in fact, be seriously impaired if the establishment of the composite gold standard were to be the occasion for reducing holdings of dollars and other currencies as monetary reserves or for limiting the growth of the resources of the Fund.

Under the composite gold standard, the creation of Reserve Units could be determined in an orderly way so that the growth of aggregate monetary reserves would not be dependent on the uncertain behavior of the balance of payments of the reserve currency countries. The Reserve Units would be created by depositing the constituent national currencies with the Fund, as trustee. The initial amount could be on a moderate scale and subsequent increases could be determined by the actual need for additional monetary reserves. As the outstanding amount of Reserve Units was gradually increased, the ratio in which they would be held and used in conjunction with gold would be correspondingly increased. This would facilitate an appropriate growth in international liquidity and an adequate supply of the monetary reserves constituting the ultimate international reserve asset.

The purpose of the composite standard is to enable gold to function more effectively by supplementing gold reserves with Reserve Units. The reason for using the currencies of the large industrial countries as the constituents of the Reserve Unit is that they are the currencies that are widely used in international trade and finance, for which convertibility into an ultimate international reserve asset is essential. They are also the countries that are accumulating the greater part of the gold added to monetary reserves. The composite gold standard would be a cooperative arrangement among the Group of Ten and Switzerland for dealing with gold reserves and gold convertibility in much the same way as the Gold Pool is a cooperative arrangement for dealing with gold sales and purchases in the London market. In fact, the composite gold standard would establish the equivalent of a pool in the gold transactions of the participating countries with the rest of the world.

The report of the Group of Ten takes note of the proposal to establish a new reserve asset in the form of Reserve Units which could be created according to appraised overall needs. The report also notes the possibility of converting a part of the Fund quota, similar to the gold tranche, into a reserve asset which could, if necessary, be enlarged to meet an agreed need. In the opinion of the Group of Ten, the creation of reserve assets, even in these forms, raises many complex

questions. They have therefore established a Study Group on the Creation of Reserve Assets which will assemble the elements necessary for evaluation of the various proposals and report to the deputies. While this is not a commitment by the participating countries to any plan, it does reveal a readiness to explore every aspect of the problem of monetary reserves.

Concluding observations

International liquidity is a complex problem that takes different forms for different countries. It is not the same, for example, for the large industrial countries as for the developing countries. For the latter, the problem is essentially how to secure access to reserve credit facilities to meet balance of payments deficits without the necessity of investing large resources in monetary reserves. For the former, the problem is not merely one of adequate reserves and reserve credit facilities, but of a proper relationship among different types of reserves.

As the report of the Group of Ten states, "there is no single, unique manner in which the growing requirements for liquidity have to be met." The evolution of the international monetary system must include diverse measures to meet diverse needs. The growth of international liquidity will have to include not only the normal increase in gold and foreign exchange reserves, but an increase in the quotas of the members of the Fund, and the conversion of the first credit tranche into a reserve asset similar to the gold tranche. To meet the special needs of the countries exporting primary products, who cannot afford to hold adequate reserves of their own, the Fund should increase the normal maximum of compensatory credits to 50 percent of the quota and should place such credits entirely outside the present quota system. The large industrial countries can meet some of the important reserve problems with which they are confronted by establishing a composite standard based on gold and Reserve Units serving together as the ultimate international reserve asset.

The two reports provide the basis for a practical program for meeting the liquidity needs of the world economy through the evolution of the present international monetary system. Such a program need not involve a radical departure from established institutions or from accepted methods of holding and using reserves. It would not make the supply of international liquidity dependent on the decisions of an international body in which there is a natural conflict between those who wish more expansion and those who wish less expansion. Instead, such a program would give countries assurance that reserves and reserve credits will grow at a satisfactory rate and that the special problems of all countries, whether financial centers or exporters of basic commodities, would be properly and adequately met.

THE UNDERDEVELOPED COUNTRIES AND MONETARY RESERVES

(By Edward M. Bernstein, March 24, 1965)

SUMMARY AND CONCLUSIONS

The underdeveloped countries have the same interest as other countries in improving the present reserve system. The basic reserve problem of the underdeveloped countries is that their reserves are too small to meet ordinary fluctuations in their balance of payments. The underdeveloped countries hold about \$12.3 billion of reserves (17 percent of the total outside the Communist bloc), but about one-fourth of these reserves are held by six oil-producing countries. These countries cannot afford to invest real resources in reserves. For this reason, their needs will have to be met out of a common reserve to which they have access when they have balance-of-payments difficulties.

The underdeveloped countries have made great use of the IMF. Since 1947, they have drawn \$2.9 billion in various currencies and at present nearly half of the \$2.6 billion of net drawings on the Fund still outstanding are those of underdeveloped countries. On the whole, the underdeveloped countries have fared well in the general readjustment of quotas in 1959 and the readjustment that will take place this year. The interest of the underdeveloped countries is to have IMF policies on drawings made more liberal and to have its liquidity strengthened by acquiring more of the currencies of the surplus countries of Europe.

The present system of providing monetary reserves is not satisfactory for the longrun needs of the world economy. Professor Triffin has proposed that the IMF be converted into a world central bank with the power to create reserves through loans and open market operations. There could be no consensus on how much reserves should be created by a world central bank, it would be impossible to secure a steady increase in reserves through loans, and open market operations would place an even greater burden on the reserve centers than they bear now. Mr. Stamp's suggestion that the world central bank could create reserves by buying bonds of the IDA would add nothing to the flexibility of the Triffin proposal, it would be unacceptable to the industrial countries, and it would reduce the present flow of aid for development.

The proposal for a composite gold standard in which the industrial countries would convert their currencies two-thirds in gold and one-third in Reserve Units would provide for an orderly growth of reserves, diminish dependence on dollars and sterling in the growth of reserves, and maintain gold settlements at an acceptable level. The Reserve Units would consist of the currencies of the participating countries (80 percent) and claims on the International Monetary Fund (20 percent). The International Monetary Fund would be able to sell the

Reserve Units it acquires for the currencies of surplus countries, thus strengthening its liquidity.

This is an evolution of the present reserve system. Gold and foreign exchange would continue to be used as reserves, although the pressure on gold reserves would be reduced through joint use with Reserve Units. The International Monetary Fund would be strengthened and would be in a position to liberalize its drawing policies, particularly on compensatory credits. This is the best way of meeting the reserve needs of the underdeveloped as well as the industrial countries.

THE UNDERDEVELOPED COUNTRIES AND MONETARY RESERVES

Reserve problems of underdeveloped countries

The interest of the underdeveloped countries in the international monetary system is essentially the same as that of all other countries.¹ The underdeveloped countries want an international monetary system under which the world economy can function effectively. That is to say, they want a system under which world trade can expand, under which private foreign investment can flow in increasing amounts from the developed to the underdeveloped countries, and under which the large industrial countries maintain a reasonably satisfactory balance of payments so that they will not be inhibited from extending grants and credits for development. Apart from their general interest in having an international monetary system suited to the needs of the world economy, the underdeveloped countries have reserve problems that are particular to them. For this reason, they are interested in seeing that the international monetary arrangements take account of their reserve needs and provide facilities for meeting them.

The basic reserve problem of the underdeveloped countries is that their reserves (gold, foreign exchange, and net creditor position in the International Monetary Fund) are far too small to meet the ordinary fluctuations in their balance of payments. At the end of 1964, the gross reserves of the underdeveloped countries amounted to about \$12.3 billion—say, 17 percent of the total reserve of all countries outside the Communist bloc. There are great differences among the underdeveloped countries in their holdings of reserves. About one-fourth of the holdings of the underdeveloped countries is concentrated in about six oil-producing countries. For the rest, while there are a very few countries relatively well supplied with reserves, there are many others, including large trading countries, with exceptionally small reserves, and in some of these instances the monetary authorities have considerable short-term liabilities, so that the net reserve position is actually negative.

The reserves of the underdeveloped countries fluctuate with the demand for their exports, rising in a period of rapid growth in the world economy and falling in a period of slower growth. At present, the gross monetary reserves of the underdeveloped countries are larger than they have been since the end of 1959. They are, nevertheless, only about the same as they were at the end of 1948 and considerably

¹ In this paper, the underdeveloped countries are defined to include all of Latin America, all of Africa except South Africa, and all of Asia except Japan. Some of the countries in this group have higher levels of per capita income than a few countries in Europe, so that the classification is for convenience regional.

smaller than they were at the end of 1956. The outstanding fact is that in a world in which gross monetary reserves increased by about \$12 billion in the last 8 years, the reserves of the underdeveloped countries actually declined. From 1956 to 1964, the imports of the underdeveloped countries increased by one-third and their nontrade payments rose substantially, while their reserves fell by about 10 percent. The monetary reserves of the underdeveloped countries were too small for their needs 8 years ago; they are grossly inadequate for their needs today.

The inability of the underdeveloped countries to accumulate reserves does not arise from a world shortage of monetary reserves. It is a reflection of the fact that reserves are a form of investment and that the underdeveloped countries cannot afford to invest real resources in monetary reserves at a time when they are desperately short of capital for development. No change in the international monetary system that would provide for a regular growth of reserves, even on a generous scale, could induce the underdeveloped countries to accumulate adequate reserves. If their reserve needs are to be met, it will have to be from a common reserve to which they have access when they have balance of payments difficulties.

Quotas, resources, and liquidity of the Fund

Without their drawings on the International Monetary Fund, it would have been impossible for some of the underdeveloped countries to meet their balance of payments problems without very severe restrictions. As these countries are dependent on the Fund to provide them with supplementary reserves, it is essential that the Fund have adequate resources and that the quotas of the underdeveloped countries be on a scale commensurate with their needs. The Fund Agreement provides for a quinquennial review of quotas. It also provides for considering particular quotas at any time at the request of the members concerned. Under these provisions, the Fund has made numerous adjustments of individual quotas and has had two general increases of quotas. In 1959, the quotas of most members of the Fund were increased by 50 percent, with the increase somewhat larger for a number of countries. The Executive Board of the Fund has just recommended that the quotas of most members of the Fund be increased by 25 percent, with 16 countries, including four underdeveloped countries, given larger quota increases.

On the whole, the underdeveloped countries have fared very well in the adjustment of quotas. At Bretton Woods, the quotas assigned to the present members of the Fund from the underdeveloped countries amounted to \$780 million. After the adjustment of 1959, the quotas of these same countries amounted to \$1,780 million, including the quota assigned to Pakistan. With the new adjustment of quotas this year, the quotas of the underdeveloped countries who were original members of the Fund will be \$2,870 million. Thus, after the proposed increase, the quotas of these underdeveloped countries will be about 3.7 times their original quotas, while the quotas for most industrial countries will be 2.0 times their original quotas. Allowance must also be made for the fact that whereas there were only 26 underdeveloped countries among the original members (including Pakistan), there are now 77 underdeveloped countries that are members of the Fund. In 1947, the quotas of the 26 underdeveloped countries ac-

counted for 10 percent of the total quotas of the original members still in the Fund. After the adoption of the resolutions recently voted by the Executive Board, the new quotas of the 77 underdeveloped countries will constitute 27 percent of the total new quotas of the Fund.

It would be a mistake, however, to assume that it is necessarily to the advantage of the underdeveloped countries to have the largest proportionate increase in quotas. That would only be true if the liquidity of the Fund were increased sufficiently to enable it to finance the quota needs of its members in the currencies of the surplus countries. The liquidity of the Fund, at any given time, can be measured by a comparison of its resources in the currencies of the surplus countries plus gold and the unused quotas of all members. The ratio of the supply of these needed resources relative to the potential drawings on the Fund gives an indication of its capacity to meet the requests of its members for drawings. When the Fund began operations on March 1, 1947, it held about \$3.4 billion in U.S. dollars and gold. The total drawing rights of all members (the quotas plus their gold tranches) amounted to about \$8.6 billion, excluding China which has never paid its subscription. Although the United States was the only major surplus country, the Fund's holdings of dollars and gold were equal to 40 percent of the total drawing rights of all countries.

The liquidity of the Fund has been very much reduced since then. With over 60 additional members, with greatly increased quotas for many members, with large drawings outstanding, and with the emergence of payments difficulties in the United States and the United Kingdom, the Fund's holdings of the currencies of the principal surplus countries and of gold are now very much smaller relative to total drawing rights. Dollars and sterling cannot be used at this time without aggravating the payments difficulties of the United States and the United Kingdom. The Fund's holdings of the currencies of the other large industrial countries are now only \$1.8 billion, even after borrowing \$400 million from 8 of the 10 large industrial countries. Its holdings of gold are just under \$3 billion. Thus, the Fund holds \$4.8 billion of gold and the principal surplus currencies against total drawing rights of over \$18 billion. The ratio of the Fund's holdings of gold plus the currencies of the principal surplus countries to total drawing rights is about 27 percent. This will be improved somewhat when the new quotas are adopted.

The Fund does not and cannot hold in hand enough liquid resources to meet the potential needs of countries like the United States and the United Kingdom as well as the needs of other countries that may have payments difficulties. That is why the Fund has entered into General Arrangements To Borrow under which its 10 large industrial members undertake to provide the Fund up to \$6 billion in their currencies under certain conditions.² The Fund has already borrowed over \$400 million from 8 of the 10 countries (of which \$280 million was from Germany and France) to help meet the recent drawing of \$1 billion by the United Kingdom. One important step that can be taken to

² The countries that have entered into the General Arrangements To Borrow and the amounts they undertake to lend are: Belgium, \$150 million; Canada, \$200 million; France, \$550 million; Germany, \$1 billion; Italy, \$550 million; Japan, \$250 million; Netherlands, \$200 million; Sweden, \$100 million; the United Kingdom, \$1 billion; and the United States, \$2 billion. Switzerland, not a member of the Fund, has made parallel arrangements to provide credit to the other countries whenever the Fund borrows.

strengthen the Fund is to give it greater assurance of being able to secure the credits provided by the General Arrangements To Borrow. Some means should also be found to replenish the Fund's holdings of the currencies of the large surplus countries without resorting to the General Arrangements To Borrow.

Policies of the Fund on drawings

The use that countries can make of the resources of the Fund depends not only on their quotas, but on its policies regarding drawings. Actually, the underdeveloped countries have made considerable use of the facilities of the Fund. Since operations were begun in 1947, the Fund has provided \$2,860 million in various currencies to 36 underdeveloped countries. At the end of January 1965, 30 underdeveloped countries accounted for nearly 50 percent of the \$2.6 billion of net drawings still outstanding.

This is the best evidence of the importance of the Fund as a source of supplementary reserves for the underdeveloped countries. As these countries do not and apparently cannot hold enough reserves of their own, it is essential for them to have assured access to the Fund. At present, members of the Fund have complete assurance that they can draw on their quotas if they have a net credit position in the Fund. This net credit, generally referred to as the gold tranche, is virtually equivalent to a country's own reserves. For drawings beyond the gold tranche, members must show that they are taking the necessary steps to put their payments in order. For the first credit tranche (25 percent of the quota), the Fund is generous in allowing members to draw. With each successive credit tranche, the Fund requires more positive evidence that members are taking the necessary steps to eliminate their payments deficit. Unfortunately, at times a member country and the Fund are not in full agreement on the corrective measures that should be taken.

As an abstract proposition, it is not unreasonable for the Fund to insist that countries with payments difficulties adopt a program to place their payments in order. The question is whether the Fund is right in making agreement on a program a precondition to the use of its resources in every case. As a practical matter, no international institution can possibly be fully informed of the payments difficulties that confront 102 countries, with institutional arrangements of their own, and with problems peculiar to them. Because of this, there is a tendency for the policy recommendations of the Fund to follow a formula, too often one that is based on the institutional arrangements of the large industrial countries. By insisting on such a program, the Fund may unwittingly set different standards for drawings—one for the underdeveloped countries and another for industrial countries.

When a country has a balance of payments problem, it should be able to draw on its quota, within the limit of 25 percent in a 12-month period, as if it were using its own reserves. Certainly this right should be given to all members for the first credit tranche and preferably for the first two credit tranches of its quota. The minutes of the preliminary meetings on the International Monetary Fund show that this was the way the Fund was intended to operate. A country that wants to use more than 25 percent of its quota in a 12-month period could do so only if the Fund waives the quota limitations and then only on terms and conditions prescribed by the Fund. This could

properly include agreement on a program for dealing with the payments difficulties of the member. The influence of the Fund on the policies of its members would undoubtedly be much greater if the recommendations of the Fund were not regarded as being imposed on them as a condition for using the Fund's resources.

One of the most important new measures taken by the Fund was the adoption in February 1963 of a policy of compensatory financing of fluctuations in the export receipts of countries greatly dependent on exports of primary products. When such countries are having payments difficulties because of a decline in their export receipts, they can expect the Fund to meet their requests for drawings where the shortfall is of a temporary character and is largely attributable to circumstances beyond the control of the member, provided the member will cooperate with the Fund in finding appropriate solutions for its payments difficulties. The amount of drawings outstanding under this policy may not normally exceed 25 percent of the member's quota.

In fact, there have been very few drawings under this policy because the cyclical conjuncture has been favorable for primary producers. Nevertheless, the Fund policy on compensatory credits represents an important step in meeting the special reserve needs of underdeveloped countries. As cyclical fluctuations in prices of primary products can be large and can continue for more than a year, the ordinary limit on compensatory credits should be increased to 50 percent of a member's quota. Furthermore, the policy of treating the compensatory credits as an ordinary quota tranche, although with greater assurance that requests for a drawing will be met, discriminates against countries that are not indebted to the Fund and in favor of countries that are indebted to the Fund. It would be much fairer to place the compensatory credits entirely outside the Fund system of quotas, although subject to the same repurchase rules as other drawings on the Fund.

The international monetary system

The present international monetary system is essentially one under which the members of the International Monetary Fund establish fixed exchange parities for their currencies, defined in terms of gold, with a change in the agreed parity requiring consultation with and in some instances approval by the Fund. In this respect, the present system resembles the gold standard except for the fact that countries are not as bound to the historical parities of their currencies as they formerly were. Members of the Fund need not convert their currencies into gold or foreign exchange for their own residents, but they are required to convert balances of their currencies held by the monetary authorities of other members. In practice, countries that have accepted this obligation maintain the convertibility of their currencies in the exchange market, using reserves of gold and foreign exchange for this purpose. On the whole, the system of fixed exchange parities, with all of the leading currencies on a convertible basis, has worked well. Some criticisms, however, have been directed against the present system of providing monetary reserves.

The monetary reserves of the world consist of gold, dollars, and sterling (the reserve currencies), and other foreign exchange. The reserves of all countries outside the Communist bloc amount to about \$40.5 billion in gold and about \$26 billion in foreign exchange. In addition to these reserves, which countries hold themselves, the Fund

holds resources of gold and currencies which members may draw on in accordance with the procedures of the Fund. Beyond that, the large industrial countries have reciprocal currency arrangements with each other for short-period credits under swaps.

The gold reserves of all countries outside the Communist bloc have increased by about \$2.5 billion in the past 6 years. If allowance is made for the larger gold holdings of the Fund, the increase in monetary gold since 1958 was about \$3.6 billion—an average of \$600 million a year. In the same period, the foreign exchange holdings of all countries outside the Communist bloc have increased by about \$6.5 billion, an average increase of about \$1.1 billion a year. Nearly all of the increase in foreign exchange reserves has been in the form of dollars and has been the consequence of the large and prolonged deficit in the U.S. balance of payments. There is widespread agreement that this is not a satisfactory method of providing for the growth of monetary reserves.

The criticisms of the present method may be summarized as follows:

(a) The growth of monetary reserves is fortuitous because it is too dependent on the state of the U.S. balance of payments;

(b) The large amount of dollars and sterling in the foreign exchange reserves of other countries exposes the reserve centers to the danger of massive conversion of their currencies into gold;

(c) The virtually automatic holding of dollars and sterling as monetary reserves by some countries makes it possible for the reserve centers to avoid taking corrective measures when their balance of payments is in deficit;

(d) The amount of gold is too small for a convertible currency world in which gold is the ultimate reserve asset and the United States buys and sells gold freely for the settlement of international transactions.

All of these criticisms are in some degree justified. The fact is that once the U.S. balance of payments deficit is eliminated, the growth of monetary reserves will be very small, consisting almost entirely of gold and amounting to about 1 percent of the present reserves of gold and foreign exchange. The excessive reliance on dollars and sterling as reserves exposes the United States and the United Kingdom to the risk of a serious drain on their gold reserves whenever there is a loss of confidence in these currencies or an economic or political crisis anywhere in the world. There is some truth in the view that the ability of the reserve centers to finance their payments deficits through the accumulation of their currencies by other countries diminishes the pressure on them to restore their payments position promptly. And, finally, the declining proportion of gold in total monetary reserves increases the difficulty of using gold as the ultimate reserve asset, as the settlement of international payments in this form would tend to have too sharp an impact on the world economy. These are some of the problems that should be dealt with in any program for strengthening the international monetary system.

Various proposals have been made for assuring an adequate and orderly growth of monetary reserves and for supplementing the use of gold as the ultimate reserve asset. The International Monetary Fund and the Group of Ten industrial countries have issued reports on these questions. In fact, the Group of Ten has appointed a committee to

consider the creation of new reserve assets. While it is unlikely that agreement can be reached until the U.S. balance of payments deficit has been eliminated, there is a strong probability that the present reserve system will be modified in the course of the next few years. It is of considerable importance what form the evolution of the international monetary system will take. The underdeveloped countries are interested in seeing that any changes in the present system take account of their reserve needs.

Reform of the reserve system

No discussion of the reserve problem has been given so much attention as that of Prof. Robert Triffin. His argument centers about the proposition that a shortage of monetary reserves will emerge when the U.S. balance of payments deficit is eliminated. In the meantime, he believes that the reserve currencies will remain under great pressure. He has proposed that the creation of monetary reserves be entrusted to an international central bank formed out of the International Monetary Fund. He would also have dollars and sterling gradually eliminated from monetary reserves, or, as a minimum, have some of the present holdings immobilized as deposits in the international central bank.

Professor Triffin would abolish the present system of quotas in the Fund. Countries that have a net creditor position would secure a deposit of the same amount in the international central bank; those that have a net debtor position would have a debt to the international central bank of the same amount, presumably to be paid off within a reasonable time. All countries would be required to keep a fraction (say, one-fourth) of their reserves on deposit with the international central bank. Deposits made in dollars or sterling would become an obligation of the United States and the United Kingdom and would be paid off over a longer period. Reserves denominated in a unit established by the international central bank would be created by having that institution make loans to member countries or by engaging in open market operations. The amount of reserves created in this way would be determined by the need for reserves by the world economy, in much the same way as national central banks create monetary assets.

The analogy between an international central bank and a national central bank is not realistic. There is a very wide area of common interest among the different sectors of the national economy, so that a consensus on a national monetary policy can be achieved, although not without some differences of opinion. On the other hand, the area of common interest is relatively small among different countries with different payments and monetary problems. Surplus countries are likely to believe that there is no need for an increase in monetary reserves, while deficit countries are likely to favor a large increase in monetary reserves. An international institution creating reserves is bound to take a very conservative view of international payments problems and reserves. Indeed, it is almost certain to be far stricter in extending credit to borrowers than the Fund is at present in connection with drawings under quotas.

An international central bank would encounter great difficulty in maintaining an appropriate amount of monetary reserves. There is no assurance that its loans would increase at a regular rate. In a period in which international payments are well balanced, particu-

larly if exports of the underdeveloped countries are high, there would be a tendency for loans to contract. The mere maintenance of a revolving amount of loans would soon become burdensome. Thus, if loans were to increase at an average annual rate of \$1 billion, and if such loans were for a 1-year period, it would be necessary to turn over about \$5 billion of loans in the 5th year and about \$10 billion of loans in the 10th year. The U.S. Federal Reserve System, originally conceived as providing bank reserves through discounts, soon found that it could not depend on this mechanism for the growth of bank reserves. At present only 2 percent of total Federal Reserve bank credit is provided through discounts.

Even the use of open market operations, by having an international central bank purchase securities in the United States or other countries, would not result in a satisfactory distribution of the newly created reserves unless the countries whose securities were purchased undertook an enormous increase in their own foreign loans and investments. To avoid these difficulties, Maxwell Stamp, formerly a Director of the Fund and until a few years ago an adviser to the Bank of England, has proposed that the international central bank purchase the securities of the International Development Association—an international agency that makes soft loans out of money contributed to it. When IDA makes loans to underdeveloped countries, they would be given deposit credits at the international central bank, and when these deposits are spent, they would come into the hands of surplus countries and become part of their reserves. According to Mr. Stamp, this plan would have the beneficial effect of creating monetary reserves that could be acquired by the industrial countries, while at the same time helping the underdeveloped countries. It is doubtful whether such a plan would assure a regular increase in monetary reserves, as there is ordinarily a considerable time lapse between the making of development loans by IDA and their disbursement.

Most important, it is open to question whether the Stamp plan would be acceptable to the industrial countries or beneficial to the underdeveloped countries. It is hardly credible that the surplus countries that are now reluctant to increase the dollar and sterling component of their monetary reserves would regard claims on an international central bank, backed by the bonds of a soft-loan agency, as an acceptable reserve asset. As a practical matter, it is doubtful whether soft loans made through the creation of reserves would be a net addition to the resources now available to the underdeveloped countries. The reserves that could be created in this way could not exceed \$1 billion a year, a very small fraction of what is now available from grants and credits. The United States argues, with more or less conviction, that the adverse effect of aid on its balance of payments is negligible. If reserves were created as a means of giving aid for development, it would be in the interest of the United States to give less aid in order to earn more of the reserves created for this purpose.

Composite gold standard

The present system of monetary reserves based on gold, foreign exchange, and the resources of the International Monetary Fund has evolved over a long period in response to the needs of the world economy. There is no reason for making radical changes in this system. It is necessary, however, to take steps that would assure the proper

functioning of the international monetary system. As the increment of dollars in monetary reserves will be small or negligible, once the U.S. balance-of-payments deficit is eliminated, some other means must be found to assure an adequate and orderly growth of monetary reserves. Furthermore, if international settlements are to continue to be based largely on gold, some means must be found to supplement gold as the ultimate reserve asset.

The suggestion has been made that other currencies be used in addition to dollars and sterling as foreign exchange reserves. Professor Zolotas of the Bank of Greece has been urging such a policy for a number of years; and Professor Posthuma of the Netherlands Bank has proposed that all countries keep agreed proportions of their reserves in gold and foreign exchange. Unfortunately, except in the United States and the United Kingdom, the money and exchange markets are not broad enough to absorb the operations incident to the use of national currencies as reserves. Professor Posthuma's proposal would reduce the excessive dependence on gold, although it would be necessary to avoid disturbances arising from the shift of foreign exchange reserves from one currency to another. Furthermore, Professor Posthuma's plan does not provide a satisfactory method for securing an orderly growth in monetary reserves.

These difficulties could be met by having a foreign exchange Reserve Unit consisting of the currencies of the large industrial countries and claims on the Fund and requiring the participating countries to hold and to use Reserve Units jointly with gold as a part of a composite gold standard. The growth of reserves could be kept at an appropriate level through the amount of Reserve Units that are created. The joint use of Reserve Units with gold would reduce the present excessive dependence on gold as the ultimate reserve asset used in international settlements. This is a problem of special concern to the United States and the United Kingdom, confronted with the possibility of large conversions of the reserve currencies into gold, and to the other large industrial countries that account for the major part of the holdings of monetary gold and among whom large movements of liquid capital can and do take place.

The large industrial countries are already doing a great deal to assure the proper functioning of the international monetary system. They have entered into the General Arrangements To Borrow under which they undertake to lend the Fund up to \$6 billion in their currencies if supplementary resources are needed to deal with an impairment of the international monetary system. These countries have reciprocal currency arrangements with the United States for credits in the form of swaps aggregating \$2.3 billion, as well as other reserve credit arrangements with each other. The currencies of these countries are widely used in international trade and payments, and they comprise about 98 percent of the over \$9 billion of exchange drawn from the Fund. In every important sense, these countries have a special responsibility in establishing a workable international monetary system. They can fulfill that responsibility by establishing a composite gold standard.

The Fund should have a special role in the composite gold standard. This should take the form of participation in the creation of Reserve Units and in the administration of the system. It is suggested that the Reserve Unit, equal in value to \$1 in gold, should be comprised of

80 cents in the currencies of the participating countries in agreed proportions. The remaining 20 cents of the Reserve Unit would be in the form of a claim on the Fund. The Reserve Units would be created by having the participating countries deposit their own currencies, in the agreed proportions, with the Fund as Trustee. Each country would be given a deposit credit in Reserve Units on the books of the Trustee equal to the amount of its own currency used as backing for the Reserve Unit. The Fund itself, not as a Trustee, would receive 20 percent of the Reserve Units created, contributing as backing its obligation in equal amount, to be met in gold or in the currencies of the participating countries whenever there is occasion to convert Reserve Units into their constituent currencies.

Each country would undertake to hold Reserve Units in an agreed ratio to its gold reserves—say, \$1 in Reserve Units to \$2 in gold. Participating countries that hold reserves in dollars or other currencies would not hold Reserve Units jointly with such foreign exchange reserves. When a participating country with a balance-of-payments surplus presents the currency of another participating country for conversion, it would receive two-thirds of the amount in gold and one-third in Reserve Units. In order to avoid a too rapid expansion of reserves, the amount of Reserve Units created each year should be moderate, say, about \$1 billion a year, until the agreed proportion to gold is reached. In this interim period countries would not have to hold the agreed ratio of Reserve Units to gold, but conversion of the currencies of the participating countries would be in the ratio of \$2 in gold and \$1 in Reserve Units.

Under this proposal, the Fund would be allotted 20 percent of the Reserve Units created for the composite gold standard. As the Fund does not need Reserve Units for its own operations, it would sell its Reserve Units to the participating countries, getting in return their currencies. This will enable the Fund to build up its holdings of the currencies most widely used in its operations and thus to strengthen its liquidity to a significant extent. With the additional currencies it acquires from the creation and sale of Reserve Units, the Fund could be much more helpful in providing resources for its members to enable them to meet their reserve problems.

The Reserve Units would be the instrument through which a participating surplus country would extend credit to a participating deficit country. In this respect, the credits granted under the composite gold standard would be similar to the credits these countries now make available to each other under the reciprocal currency arrangements. At present, not all of the swap facilities can be used when a participating country has a balance of payments deficit. Some of the participating countries may have payments difficulties; and others may not permit their currencies to be used in exchange market operations. Furthermore, the swaps are short-term credits that must be reversed in 3 months to a year. In a sense, the composite gold standard would be equivalent to the simultaneous activation of all the swaps by depositing the currencies with the Fund, as Trustee, and designating them in Reserve Units. Thus, all of the currencies would be fully utilizable in international settlements, and the Reserve Units which these currencies represent would have a defined role in international settlements along with gold.

Significance to the underdeveloped countries

The underdeveloped countries are very short of reserves. As a practical matter, it would be in their longrun interest to hold larger monetary reserves. Unfortunately, they are so pressed for capital for development that most of them do not feel that they can afford to invest real resources in building up their reserves. No system of providing for a more orderly growth of monetary reserves is likely to change their attitude on the holding of reserves. Under the circumstances, their interest in new monetary arrangements is essentially to have a system under which the world economy can function most effectively. Apart from that, it is in their interest to see that the Fund is better provided with resources for a common reserve on which they can draw.

It is not in the interest of the underdeveloped countries to have the International Monetary Fund converted into a central bank which creates reserves by extending loans or engaging in open market operations. The present system of quotas gives the members of the Fund a presumptive, although qualified, right to draw on its resources when they have balance-of-payments problems. At worst, a country that wishes to draw on the Fund must now show that it is willing to undertake a program to restore its balance of payments. With an international central bank that provides loans, a country that needs help with its balance of payments would not only be subject to this test, but it might be subject to a general policy of making monetary reserves easier or tighter according to some nebulous concept of the needs of the world economy. The underdeveloped countries would be far better off with the present system of operating the Fund, although it would be desirable to have greater assurance on the use of Fund resources and a more liberal policy on compensatory credits to finance fluctuations in export receipts.

The Stamp plan for the creation of reserves through development loans seems at first sight to have some advantages to the underdeveloped countries. This is illusory. Such a system of creating reserves is wholly impractical and would not receive the necessary international support. Furthermore, aid that is distributed by way of loans to create reserves might be more than offset by a reduction of grants and credits made directly by the industrial countries or through their contributions to international organizations. Countries with a balance-of-payments problem, such as the United States, would be under great pressure to reduce their aid in order to earn more of the reserves created for aid purposes. The underdeveloped countries are greatly in need of additional resources to accelerate their development. This should come from larger grants and credits by the high-income countries. It cannot possible come from the relatively small creation of monetary reserves allocated to aid.

The proposal for a composite gold standard is designed to improve the working of the international monetary system. It is for this reason of general interest to the underdeveloped countries. The composite gold standard would not change the role of dollars and sterling as reserve currencies, although no country would be obligated to hold reserves in this form. By strengthening the international monetary system, the composite gold standard would make it possible for the large industrial countries to increase private foreign investment and Government grants and credits to help the underdeveloped countries.

Finally, if 20 percent of the Reserve Units created through the composite gold standard were allotted to the Fund, it would improve the liquidity of the Fund and make it possible for that institution to pursue a more generous policy on drawings. As the Fund must inevitably be the principal source of supplementary reserves for the underdeveloped countries, a practical plan for raising the liquidity of the Fund is of the greatest importance to them.

EXCERPTS FROM "INTERNATIONAL LIQUIDITY: TOWARD A HOME REPAIR MANUAL" BY RICHARD E. CAVES

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THE SUBSTANTIVE ISSUES

The available proposals for reforming international liquidity arrangements appear to differ greatly in their details. Yet one gains the impression of a profusion of carts preceding some highly relevant horses. International reserves simply constitute one facet of the international monetary system. There is little hope of debating the merits of competing international liquidity plans, each tricked out with gimmicks which conceal assumptions about how the overall system is to work, until we have settled on the properties of the system itself. Assuming that fixed exchange rates remain the order of the day, the following issues seem to be the crucial ones.

When and for how long shall deficits be financed? The question of supplemental liquidity arrangements is essentially one of the standing commitments which countries will make to finance others' payments deficits when they themselves are in surplus. To the extent that the deficit country holds reserves of internationally acceptable means of payment, it can finance its deficit directly. The surplus country "accommodates" this financing automatically by the standing willingness of its monetary authority to receive these means of payment. A potential surplus country supplements available liquidity by agreeing in advance to provide additional accommodation beyond the deficit country's stock of reserves. The actual transactions in which the surplus country honors this prior commitment can take a multitude of forms, and therein the many proposals for increasing liquidity differ.

Behind these mechanics of the accommodating or support transaction lie the basic substantive questions of the terms under which accommodation will be given. These might be broken down as follows:

(1) How large a deficit will the surplus country accommodate? Since a deficit can be thought of as having both a rate (how much per year?) and a duration (how many years?), the surplus country's maximum commitment can be fixed in terms of either a rate of assistance, a cumulative amount of assistance, or both. Since many countries can be in deficit, and many in surplus, at any given time, the commitment to accommodate in a multilateral system can take complex forms. There may be limits on the amount of aid which the surplus countries agree to give per unit of time, independent of the drawing rights or needs of the deficit countries; or, instead, the rights of the individual debtors to receive assistance may be fixed, so that the creditor's obligation in a given year varies with the number of needy deficit

countries. In the present IMF, the surplus countries are essentially protected in their maximum obligation to assist by the stock of gold and usable currencies which they have previously committed to the Fund.

(2) What shall be the maturity of the claims which the creditor country acquires for its assistance? These can be either fixed or unlimited in time. As one approach, the debtor may be required to redeem his obligation in internationally acceptable means of payment within a fixed period, or a fixed period subject to renewals. As another approach, the creditor may hold an open-ended claim usable when he himself swings into a deficit position. The debtor's liability to the creditor may be either transferable or nontransferable; that is, the creditor may or may not be able to "cash" it with third countries in exchange for internationally acceptable means of payment.

(3) Shall the potential surplus country's prior commitment to accommodate deficits be conditioned upon the source or cause of the deficit? The real costs of assistance to the surplus country are the same in any case, but potential creditors may feel that deficit countries are more deserving of assistance when suffering from some ills than others. Besides limits on the rate or cumulative size of the deficit financed, are there also limits relating to the type and source of the deficit?

How automatic shall the accommodation of deficits be? At one extreme, the surplus countries may give a prior commitment to accommodate deficits automatically up to some predetermined limit. At the other extreme, no formal arrangement may exist at all for accommodation, except that potential surplus countries state their willingness to consider requests on an ad hoc basis. In between, many sorts of terms and conditions can be attached to the access of deficit countries to assistance. The creditor country can limit its obligation either by setting a maximum on the help it will give automatically, or scrutinizing the policies of the deficit country to make sure that the amount of help asked will be reasonably limited, or some combination of the two. Where aid is not automatic, the political forum within which eligibility for assistance is determined takes on great importance. The main issues would be the following:

(1) Should the source of the deficit make a difference for how automatically assistance is rendered? Determining a unique economic cause for a deficit is seldom easy and sometimes impossible, but potential surplus countries may still wish to impute such causes and restrict accommodation to deficits honestly come by. They may wish to discriminate between deficits originating in domestic policies of the deficit country and those stemming from events outside its control. They may wish to discriminate between domestic policies which have involved tolerating inflation and those which have not.

(2) Should accommodation depend on the policies currently in use in the deficit country? Should it have to take actions through domestic policy which meet certain criteria, as part of the price for receiving either initial or continued assistance? Making the accommodation of deficits contingent upon the past or present domestic policies pursued by deficit countries has important implications. It constitutes a mutual self-denying ordinance among the members of

the agreement. At best, it gives an extra measure of backbone against pursuing domestic policies which might be expedient in the short run, but dangerous or harmful in the long run. At worst, it arbitrarily restricts the potential deficit country from choosing policies which might be quite desirable and provides a ground for bickering among countries as to whether or not wrong policies have been chosen and right ones pursued with proper vigor.

(3) Should the accommodation open to a deficit country depend on the amount of accommodation it has given to others in the past? No very strong economic case can be made for rendering assistance to a deficit country more or less readily because of a past history of surpluses or deficits. If chronic deficits result from an unwise choice of economic policies, to make aid conditional on the basis of policy reform would seem to approach the problem more directly. Nonetheless, nations may commonly feel that somebody who has helped out in the past deserves accommodations more than somebody who has not, and this may be a condition for the receipt of assistance.

(4) Should any conditions attached to the accommodation of a deficit affect any and all assistance given, or should their pressure depend on the relative amount of assistance sought? Present policies of the IMF make part of a country's drawing rights (the gold tranche) available almost automatically. Further cumulative borrowing brings increasingly close scrutiny of the causes of the deficit and of past and present policies. An alternative approach makes the attachment of conditions total rather than progressive. Either the full assistance warranted is given, or none, depending on whether the conditions are satisfied.

(5) When the accommodation of deficits is subject to conditions, what body makes the political decision about whether the conditions have been met? Should it be an international organization, with constitutionally fixed voting rights apportioned among a large membership such as the present IMF? Should it be a club of major trading nations, with fixed voting rights based upon some prior agreement? Should the voting rights with regard to a particular accommodation rest upon the current pattern of payments deficits and surpluses among those countries eligible to vote, and, if so, how should the weights lie as among the deficit and surplus countries?

Cutting across these questions about the distribution of voting rights among participating countries is the question of what sector of government within each country shall exercise its vote. Specifically, shall this power rest with the central bankers or with persons directly responsible to the political executive? In questions relating to balance of payments policy, central bank officials may have preferences different from the executive, such as aversion to any policies which, whatever their other goals, might entail increases in the general price level, or which might cause a financial capital loss to the central bank. Some people may not wish to allow the irresponsible exercise of these preferences. On the other hand, a conservative or elitist view might prefer placing such decision in the hands of central bank officials rather than in those of a politically responsible agent.

What countries shall be eligible for accommodation? For those liquidity proposals which operate within the framework of the present

gold-exchange standard, the treatment of three separate groups of countries must be considered: reserve-currency countries; non-reserve-currency countries which normally hold reserve; and non-reserve-currency countries which normally do not hold reserves, typically thought of as the less developed countries. The realistic range of choice for membership in any proposed expansion of liquidity arrangements lies between the present IMF and some "club" consisting of all or part of the major industrialized countries. Which type of approach is taken, and whether all or part of the industrial countries belong to a club, depends on how the proposed new arrangement is to work and what function it aims to fulfill.

(1) The present IMF gives access to accommodation that is mostly subject to conditions for the proper selection of domestic policies and to repayment within a relatively short period of time. This system is adaptable to the needs of any sort of country, and specifically has worked fairly well with the less developed countries. On the other hand, an arrangement providing for generous automatic assistance, or one granting assistance mainly for disturbances to the balance of payments arising from the business cycle, would be less well suited to them.

(2) The useful range of membership in any club of industrial countries depends on whether the arrangement focuses on accommodating deficits in the basic balances of the members or on averting "runs" under the gold exchange standard—cumulative switches from one reserve currency to another, from either into a major nonreserve currency, or from either into gold. Avoiding runs probably requires in practice the cooperation of monetary authorities in all countries toward which a run might head. However, multilateral arrangements for accommodating basic payments deficits would make the cooperation of the full membership of the industrial countries less necessary.

(3) If exchange value or gold guarantees are to be used among members of such a club, all countries holding substantial reserves of club members' currencies should probably be included, or the outsiders will consider their assets inferior and tend to switch from them.

(4) Some plans combine a permanent expansion of world reserves with a one-shot extension of aid from the industrial to the less developed countries.¹ An international agency could make a round of long-term loans to aid development projects in these countries, issuing to them certificates (IBRD bonds) subject to an international agreement that the industrial countries would accept these initially in payment for exports, and then hold them as part of their international reserves, and agree to accept them from other industrial countries as payment for the accommodation of payments deficits.

How should the strengthening of liquidity relate to the gold exchange standard? Plans for international reserves take widely diverse approaches toward the elements of the gold-exchange standard. This follows from the divergent appraisals of the standard implied in the different views of the liquidity problem outlined above. Persons seeing the difficulty as one of gaining further breathing space for the United States to correct its deficit, implicitly accept the gold-exchange

¹ M. Stamp, "The Fund and the Future," *Lloyds Bank Review*, No. 50 (October 1958), pp. 1-20.

standard as is, at least for the time being. Those who emphasize the problems of stability and reliability in the existing structure of reserves are impelled toward seeking fairly fundamental changes in some parts of the present system. Finally, those whose concern rests with the quantity of liquidity and its increase over time take somewhat more flexible and varied positions toward the gold exchange standard, some seeking to build upon it, others wanting its complete removal.

Proposed reforms in international liquidity can affect the role of foreign exchange or gold reserves or both.

(1) With regard to United States dollars and United Kingdom sterling now held as official reserves, some plans simply ignore them and propose arrangements for piling more reserve atop them, in the same form or in the form of other liquid assets. This involves an outright acceptance of the status quo for these reserves. Other plans seek to freeze these reserves in one fashion or another, so as to make them usable for their primary purpose of accommodating payments deficits by their present holders but to block their use for runs into gold or other currencies. Among these proposals are gold and exchange value guarantees, which their proponents hold would reduce the likelihood of runs or asset switches, and the conversion of outstanding official dollar and sterling balances into longer term securities. Some of the more elaborate plans for new liquidity arrangements call for depositing these official holdings of currency reserves with an expanded IMF. Such an action would increase the use made of an enlarged Fund and freeze the reserve-currency countries' liabilities in the hands of a supposedly reliable international holder. Finally, some proposals for changing the world's monetary system call not just for freezing foreign exchange reserves but also for a repatriation (unwinding) of them by the reserve-currency countries. Unless this repatriation comes through a direct swap of short-term for long-term liabilities, these currency reserves can be unwound only by the reserve-currency countries running surpluses in their current accounts.

(2) The recent proposals for augmenting international reserves have not often sought to make direct changes in the role of gold, probably feeling that it is too much of a sacred cow to be tackled. Critics who worry about the stability and reliability of the gold exchange standard, however, can logically put a case against the present role of gold which is about as strong as that against the present role of national currencies as reserves media. The trouble with gold is that, over the whole of modern history, its price has moved almost always up and seldom down. One-way price expectations are thereby firmly fixed, so that some speculators will always tend to move into gold, but few will ever move out. The liquidity proposals coming from those worried about the reliability and stability of the gold exchange standard would attack this problem in two different ways: (a) Raising its price enough to saturate the private market and perhaps to permit buying back the outstanding foreign-exchange liabilities; and (b) creating enough assurance that official currency reserves will not be converted to gold to dampen private expectations of a gold price increase.

Analyses of the liquidity problem stressing the quantity of liquidity point to the slow increase of official gold holdings, especially in the last 5 years, as proof that eventually *some* other safe reserve medium

must be adopted to supplement the quantity of gold. This line of thought leads to the same two types of proposals as come from a concern with the reliability of the gold-exchange standard: (a) A general rise in the price of gold would constitute both a one-shot increase in the value of the present stock of monetary gold and an increase in the value of the annual physical additions to monetary gold stocks; and (b) a new method of adding to the stock of liquid international reserves would reduce the incentive for countries to employ policies aimed at conserving their gold stock which are harmful to the world economy at large.

How do liquidity proposals relate to the "adjustable-peg" system of exchange rate adjustment? Members of the IMF are committed in principle to the Bretton Woods system of managing their exchange rates—holding them constant in the face of ordinary deficits or surpluses and in case of capital flight, adjusting them in the face of fundamental disequilibrium. The crucial concept of fundamental disequilibrium is left undefined, and the actual consensus among the industrial countries has run toward the total avoidance of exchange rate changes by reserve-currency countries and their use only in dire straits by other nations.

By and large, proposals which stress increasing the quantity of liquidity seek to accommodate the wishes of countries seeking to avoid changing their exchange rates. The more reserves on hand or available, the longer a country can wait for a swing in the fortunes of its balance of payments. Furthermore, a large stock of reserves makes easier the use of domestic fiscal and monetary policy to achieve purely domestic ends without worsening the problems of the balance of payments.

Among liquidity proposals concerned with the instability of the gold exchange standard, some authors look forward to making changes in exchange rates easier. In all cases, this is done by insuring that official reserves do not take part in speculative runs associated with actual or anticipated changes in par values, or by arranging international cooperation in the use of such reserves to stop runs. Guarantees of the exchange value of official reserves and proposed expansions of the Basle agreements technique cut in this direction. Not all proponents of plans for increasing the stability of the gold exchange standard would want to encourage the use of exchange rate adjustments. Nonetheless, most plans which would increase the stability and reliability of reserves would contribute to making changes in rates a more readily usable policy instrument.

At this writing, it is not clear whether the major trading nations are on their way to a new Bretton Woods, or whether they will get no further than arguing over whether or not a problem exists. In either case, discussion needs to be promoted concerning how the international monetary system is to respond to shifts in the pattern of trade and payments, and not, for example, on whether the acceptance of deposits by the IMF is preferable to the reciprocal acquisition of key currencies. Herbert Grubel has already appropriated the most apt Lewis Carroll quotation for the circumstances:

"Would you tell me, please, which way I ought to go from here?" [asked Alice]. "That depends a good deal on where you want to get to," said the Cat.

EXCERPTS FROM "INTERNATIONAL
MONETARY ARRANGEMENTS: THE
PROBLEM OF CHOICE," INTERNA-
TIONAL FINANCE SECTION, PRINCE-
TON UNIVERSITY, 1964.

* * * * *
CHAPTER II

PROBLEMS AND OBJECTIVES

THE GROUP agreed to distinguish three major problems concerning the present international monetary system:

- (1) the problem of payments adjustment, deriving from the need for correcting persistent imbalances in the payments positions of individual countries;
- (2) the problem of international liquidity, connected with the need for long-term adaptation of the total volume of world reserves to the full potentialities of noninflationary economic growth; and
- (3) the problem of confidence in reserve media, implied in the need for avoiding sudden switches between different reserve media.

The undeniable interdependence among the three problems is no obstacle to separate treatment in theoretical analysis or practical policy. Indeed, it is the essence of analysis that it breaks apart what in fact may be inseparable.

In this chapter we shall first present preliminary statements on the nature of the three problems and the relationships among them. Since problems, however, arise chiefly when some objectives can be attained only at the expense of other objectives, we shall then proceed to a brief review of the alternative social goals which an international monetary system may serve. Different attitudes of economists toward alternative systems are conditioned in part by their preferences for various objectives of economic policy. In the next chapter we shall

return to a more elaborate discussion of the problems and of some approaches to solve them.

THE PROBLEM OF PAYMENTS ADJUSTMENT

It is appropriate, though not always easy, to distinguish between *financing* (or "cushioning") an imbalance of international payments and *adjusting* (or "correcting") the payments positions of the countries concerned. "Adjustment" is the process by which deficits and surpluses are eliminated.

The classical method of adjustment consists in a fall of money incomes, wage rates, costs, and prices in the deficit countries relative to those in the surplus countries. This can be brought about either by a change in exchange rates between the currencies of the countries concerned or by changes in the absolute levels of money incomes, wage rates, costs, and prices in some or all of the countries.

Under the orthodox gold standard, gold flows brought about these changes automatically. (It was often impossible to observe these changes in the raw statistics because (a) in perfect markets prices of internationally traded goods must move at the same rate in different countries and (b) the changes constituting the adjustment process were obscured or hidden by trend, cyclical, or accidental factors.) The changes in incomes and prices were usually accompanied by automatic or policy-determined changes in interest rates. The discount rate would be raised in deficit countries and lowered in surplus countries. This would dampen activity in the former and quicken it in the latter, thus speeding the adjustment. It also would induce private short-term capital movements, providing a "cushion" while the basic adjustments were being worked out.

Private short-term capital movements are on the borderline of "financing" and "adjustment." Many econ-

omists regard them as a method of temporary financing (a balancing item) along with "compensatory official financing"; others treat them as a short-term (temporary) adjustment (among all the other items which compose the balance of payments). Another case near the borderline is the accumulation or liquidation of commodity stocks (inventories) induced by changes in interest rates or in economic activity. Many propose that the line separating adjustment and financing be drawn between commodity stocks and short-term private capital. This is in conformity with the definition used in some official statistics, where all movements of merchandise, even if induced by changes in prices or interest rates that result from an imbalance of payments, are treated as "autonomous" items, whereas movements of private short-term capital, though similarly induced, are treated as "accommodating" items. Such classifications, of course, will always be matters of judgment and doubt.

Instead of facilitating or speeding the adjustment process, policy measures may, deliberately or unwittingly, impede or retard it. Thus, in a deficit country, the monetary authorities may resist the deflation prescribed by strict gold-standard rules and, instead, resort to expansionary measures in order to prevent unemployment from increasing; and, in a surplus country, the authorities may "sterilize" the inflowing gold in order to prevent prices from rising or to forestall the development of presumably unsustainable boom conditions.

In our time the automatic mechanism of adjustment through income and price changes has been much weakened, but by no means entirely destroyed. A deficit still has a dampening effect on economic activity but, since wage rates have become almost entirely rigid

downward, more unemployment will be created in the process than was the case in former times or in the old "model." Automatic adjustment works better in the surplus countries, especially in periods of high employment, because wages are usually flexible in the upward direction.

Many conferees argued, however, that in a progressive economy even absolute downward rigidity of wage rates need not preclude price and cost reductions. If the wage level rises less than average labor productivity, money costs and prices can gradually decline *without unemployment being created in the process*. Furthermore, the slackening of activity (with a decline of profits and overtime pay) may induce management to eliminate waste, enforce tighter labor discipline, and reduce labor turnover. This implies a reduction of labor costs per unit of output even if money wage rates per hour remain unchanged. Thus, the adjustment mechanism can work, to some extent, even if wages are entirely rigid in the downward direction, so long as it is possible to contain the upward wage-push. The process, of course, will be much slower than it would be if money wages were flexible. This is the main reason for the increasingly insistent demand that more use should be made of exchange-rate adjustments or of (limited or unlimited) exchange-rate flexibility, whereby relative costs and prices can be changed without requiring changes in their absolute levels.

Whereas the automatic mechanism of adjustment with fixed exchange rates has been weakened, the scope for deliberate policies of adjustment and the readiness to use policy measures for adjustment purposes have been increased. The vast expansion of the public sector

and of the range of government activities has added entirely new dimensions to adjustment policies.

This is not the place to survey the various possibilities. The alternatives range from (a) measures designed to facilitate and improve the smooth operation of the automatic, competitive mechanism, to (b) adjusting the government's own (noncompensatory) international transactions, to (c) restricting and regulating private transactions.

Measures of category (a) include, in deficit countries, incomes policies which effectively hold down the rise in money wages; in surplus countries, the removal or attenuation of import restrictions. Under (b) one may list changes in military expenditures, government grants and loans, and the like (though these measures are sometimes regarded as methods of financing rather than correcting an imbalance). Under (c) falls the whole arsenal of restrictions on trade and payments, such as higher tariffs, smaller quotas, stricter exchange controls, tying of loans.

The great majority of economists regard measures of category (a) as the most desirable adjustment policy, those of category (c) as the least desirable, and those of category (b) somewhere in between.

THE PROBLEM OF INTERNATIONAL LIQUIDITY

"Liquidity" is an imprecise and treacherous economic concept. Generally speaking, it refers to an economic unit's ownership of cash together with its capability to obtain cash by the sale of, or borrowing against, assets; alternatively, it may refer to the characteristics of the assets themselves, to their convertibility into cash at short notice and without appreciable loss. The concept

therefore is unambiguous only in relation to an economic unit or to a particular asset in a size or amount that is small in relation to the relevant market; the concept becomes imprecise when extended to the market, or the assets traded in the market, considered as a whole.

For an individual country, "international liquidity" means, most commonly, the command of its monetary authority over foreign exchange for use in intervening in the foreign-exchange market to support the exchange value of its currency. By intervening, the monetary authority can delay or avoid (1) the adoption of the domestic economic policies that would be required to adjust the economy so as to restore immediate payments balance at the current exchange rate, or (2) the adjustments that would be brought about by a change in the exchange rate.

When an imbalance is only temporary and due to reverse itself, the purpose of such intervention in the foreign-exchange market is to avoid unnecessary disruption of the economy. When the imbalance is longer-run or more fundamental, the purpose of such intervention is (a) to allow enough time for the working out of the "natural" adjustment processes initiated by the imbalance itself, and possibly (b) to allow the economic policy-makers to accelerate the natural adjustment processes by methods less drastic and urgent than they would otherwise be forced to adopt.

The desirable degree of international liquidity for a country depends, therefore, on the speed of operation of the natural forces of adjustment, accelerated by the pursuit of economic adjustment policies within the limits considered tolerable. The advantages of greater liquidity

to the individual country in this connection, however, must be weighed against two contrary considerations: (a) excessive liquidity may inhibit both the natural adjustment processes and the pursuit of appropriate policies of accelerating adjustment; (b) the use of liquidity involves withdrawing real resources from other countries, or acquiring claims on their real resources, and so may be unwelcome to them. Thus, liquidity and adjustment are closely linked.

The international liquidity of a country comprises a spectrum of assets and borrowing powers at the disposal of its monetary authorities, which for purposes of analysis can be classified in a variety of ways. Some of the significant distinctions are

1. between (a) actual holdings of assets and unconditional drawing rights (gold stocks, deposits in foreign banks, foreign-currency obligations of foreign governments, I.M.F. gold tranche)
and (b) unused borrowing facilities (I.M.F. credit tranches, stand-by credits, stand-by credit swaps);
2. between (a) gross reserves (all the assets and drawing rights listed under 1.a.)
and (b) net reserves (gross reserves minus current liabilities to other monetary authorities);
3. between (a) owned reserves,
(b) borrowed reserves,
and (c) borrowable reserves,
where borrowed and borrowable reserves should be further subdivided

- according to their availability (i) for short terms, (ii) for medium terms, and (iii) for long terms; and
4. between (a) owned, borrowed, and borrowable reserves under existing arrangements, (b) additional reserves obtainable through new *ad hoc* borrowing arrangements, and (c) additional reserves obtainable through restrictive domestic monetary policies and other central-bank action directed at interest rates and forward foreign-exchange rates.

For concreteness and precision the conferees agreed to confine the concept of the international liquidity of a country to the sum of owned reserves and unconditional drawing rights.

In the postwar period, the supply of additional international reserves in the form of gold has not kept pace with the growth of international trade and payments and of central-bank demand for international reserves. Not only has the supply of gold from new production and Russian gold sales grown relatively slowly, but a substantial portion of the new gold supplies has disappeared into private hoards. The remaining demand for reserves has been met in part by the establishment of the International Monetary Fund and the 1959 agreement to increase members' quotas in the Fund, but mainly by the growth of other countries' holdings of U.S. dollars as international reserves in substitution for gold. The growth of these holdings constitutes evidence of the inadequacy of gold supplies. The result has been a weakening of the international reserve position of the

dollar through the growth of U.S. short-term liabilities to foreign monetary authorities and private creditors and the diminution of U.S. gold reserves. This weakening of the U.S. position has been intensified by a loss of confidence generated by the large balance-of-payments deficits of the United States in the past seven years and the efforts the United States has been obliged to make to persuade other countries to hold more dollars and less gold than they would have preferred. Out of this experience have emerged the two problems discussed in this and the following section—the problem of international liquidity and the problem of confidence in reserve media.

The liquidity problem arises because the vagaries of such factors as Western gold production, Russian gold sales, private gold hoarding, the U.S. balance-of-payments position, and agreements to increase automatic drawing rights at the I.M.F., cannot be safely relied on to sustain the normal growth of world production, trade, and payments at a relatively stable price level. The confidence problem arises because the dollar has become a less trusted substitute for gold in other countries' international reserves, and a collapse of confidence in the dollar could lead to the large-scale destruction of international reserves through the exchange of dollars for U.S. gold holdings and thus to the disruption of the international monetary system and the liberal international economy that has been gradually restored since the war.

The international liquidity problem is the problem of reforming the international monetary system so as to provide for the growth of total international reserves at a rate consistent with the normal expansion of the world

economy under liberal trade and payments conditions, a rate, that is, which imposes neither inflationary nor deflationary pressures on world prices. Just what rate of expansion is required for this purpose is extremely difficult to specify, for a variety of reasons. In both the domestic and the international field, monetary history has been characterized by the successive development of new methods of substituting credit instruments and devices for reserve money. Some countries assess their need for international reserves by reference to their domestic production and money supply, others by reference to their international trade and payments. There are thus no solid theoretical or empirical grounds for believing that the ideal is a growth rate of international reserves invariantly related to the normal rate of growth of world output or world trade and payments. Moreover, the required increase of international reserves will depend to some extent on the magnitudes of the international imbalances expected in the future, and on the relative emphasis given to the provision of liquidity and the improvement of adjustment mechanisms.

Nevertheless, it is clear that the present system is an erratic and unreliable method of providing for the growth of international reserves. All members of the Group are agreed on the desirability of reforms designed to provide for a better-controlled and steadier growth of international reserves if the present system of (relatively) rigid exchange rates is to be maintained, though some would prefer to replace that system by a system of freely floating exchange rates, which in their opinion would eliminate the problem of international liquidity by providing an automatic mechanism for immediate adjustment of international imbalances.

THE PROBLEM OF CONFIDENCE IN RESERVE MEDIA

Even if adjustment processes and the supply of international reserves proved to be quite adequate over the long run, the international monetary system might still be subject to massive shocks. If major holders of reserves sought suddenly to substitute one international reserve asset for another, they could drain reserves from a reserve center and put unbearable strains on the adjustment mechanism. They could even cause a drastic contraction in the global total of reserve assets, subjecting the world economy to deflationary pressures.

The problem of confidence in reserve media is not unique to international monetary systems. It was an important domestic problem in the interwar period and particularly in the nineteenth century. As banknotes and bank deposits were not fully covered by the banks' gold holdings, a large-scale conversion of credit money into gold could force banks to suspend the convertibility of their notes and deposits; they could not honor their obligations. The mere fear of a suspension, in turn, could provoke a "run" on the banks. Holders of notes and deposits would seek to redeem them in gold before the banks' holdings were exhausted. These "runs" on the banks were frequent companions of business recessions in the nineteenth century, and they intensified these recessions by reducing the supply of money.

The domestic problem was brought under control with the gradual development of central banks; these serve as "lenders of last resort" to the commercial banks and help them to honor their obligations to the public. The international problem of confidence is still with us, however. The countries whose currencies are held as

reserves have no such "lender of last resort" to aid them in a crisis, but must use their own reserves to honor demands for redemption. The International Monetary Fund and other international financial institutions can assist them in a crisis, but not to the same extent that a national central bank can assist its commercial banks.

The present international system, moreover, has peculiar features that may render it even more vulnerable than a domestic monetary system. First, the supply of a particular reserve currency to other monetary authorities is most apt to increase when the country issuing that currency is in payments deficit and when foreign central banks are therefore least inclined to accumulate additional amounts of this currency. Secondly, the international reserve centers have only a small number of foreign creditors whereas an ordinary commercial bank has many depositors. This is because a handful of monetary authorities hold most of the world's reserves. Finally, the holders of reserve assets are official institutions and may be influenced by political considerations as well as by concern about the value of their assets.

At present, the problem of confidence is most often formulated with reference to the "overhang" of dollar and sterling claims held as reserves by other monetary authorities. These authorities might begin massive conversions of dollars into gold. There might also be massive private outflows of dollars or sterling which would transfer more dollars or sterling to foreign central banks than they care to hold. Large-scale conversions of dollars or sterling into gold could easily demolish the present international monetary system. Thus, while the present currency-reserve system is sometimes accused of imparting an inflationary bias to the process of payments ad-

justment and thus to the world economy, it could also be accused of threatening massive deflation.

Other monetary systems too may encounter the problem of confidence. The form of the problem is likely to differ from one approach or plan to the next, but every system should be examined from this point of view.

RELATIONSHIPS AMONG THE THREE PROBLEMS

The problems of payments adjustment, international liquidity, and confidence in reserve media are closely related. If the adjustment mechanism works fast, either automatically or speeded by policy measures, the need for liquidity is low. If the adjustment mechanism or adjustment measures work slowly, the need for liquidity is high. Conversely, the speed and character of adjustment are likely to be affected by the magnitude of the available reserves and the ease with which gross reserves can be replenished.

A deficit country that has large reserves or can easily increase its gross reserves by borrowing will be less inclined to speed up adjustment by appropriate policy measures than a deficit country that has small reserves and cannot easily borrow from abroad. The reaction of the surplus country to greater reserves is different; the larger its reserves and the easier its access to foreign credit, the less will the surplus country be inclined to let its reserves accumulate further and, hence, the less reluctant it may become to speed up the adjustment mechanism.

It follows that the creation of additional reserves by borrowing arrangements, or some other device, is likely to shift more of the responsibility for adjustment from the deficit to the surplus countries. This means that sur-

plus countries tend to bear the main burden of *excess liquidity* in the world at large, since reserves, no matter how they are distributed initially, will eventually be re-distributed to the surplus countries; conversely, deficit countries tend to bear the main burden of *deficient liquidity*.

Liquidity and adjustment are also closely related to the question of confidence. As reserve-currency countries run deficits, gross liquidity increases, but confidence may after a point be diminished. On the other hand, as such countries undertake adjustment, liquidity may be reduced, but confidence enhanced. By the same token, the action of a reserve-currency country in augmenting its own liquidity, through the generation of a balance-of-payments surplus, necessarily diminishes world liquidity while restoring world confidence in that reserve currency. The role of a reserve-currency country as provider of reserve assets may therefore conflict with its role as provider of a *safe* reserve asset.

To put it differently, the rate at which a reserve-currency country runs a deficit cannot simultaneously perform two functions: that of increasing liquidity at an appropriate rate and that of maintaining confidence in the convertibility of its currency into gold.

OBJECTIVES AND CONFLICTS

Our civilization attaches the highest value to man and the development of his capacities, which is why we regard personal freedom as a fundamental social objective. The emphasis on the value of man also involves the recognition of other objectives: to enable man to consider himself a useful member of society and, therefore, to find gainful employment; and to work toward

the abolition of poverty. These general goals of society imply the following more specific objectives in the economic sphere:

1. a high and stable level of employment;
2. the highest possible per-capita income, requiring
 - (a) an efficient allocation of resources among countries as well as within them, and
 - (b) a high rate of growth; and
3. a continuing special regard for poorer persons and nations.

Unlimited freedom for one may curtail the freedom of others; hence the need for collective authority on the local, national, and international level to assure a peaceful and equitable society. Another function of authority is to create institutions and rules designed to harness the selfish actions of persons and nations to the collective good. All of us agree that individual actions must be limited and supplemented by national policies to attain the above objectives, and that national policies must be limited by cooperation among nations. We also subscribe to the principle of "devolution": decisions safe in the hands of individuals should not be given to national governments, and decisions that can be left to national governments should not be arrogated by international or supranational institutions. Within these limits, however, we differ on the ideal mix between individual action and central control, on how much the individual's freedom of decision should be encroached upon by government action, and to what extent sovereign national economic policies should be constrained in the interest of international cooperation, equity, and harmony. Furthermore, we also disagree frequently on what we consider the best institutions and policies, and their best

combination on the national and international level, for the achievement of universally agreed-upon objectives.

Efficient resource allocation among countries is usually facilitated by (1) the free convertibility of national currencies and (2) the free movement of products, people, and capital. These are not only conditions of efficient resource allocation but also means to another end, inasmuch as they enhance personal freedom. Most of us also believe that (3) aid to developing countries is necessary to achieve a more equitable distribution of the world's resources.

All of us favor (4) a reasonably stable price level as a condition of growth or as a means of promoting equity in income distribution or both; some consider (5) stability of foreign-exchange rates as a factor that promotes effective international division of labor, since that alone tends to put external economic relations on a par with domestic relations in terms of predictability.

Under present circumstances, the pursuit of these instrumental objectives is subject to the overriding constraint that (6) each country's external accounts must eventually be balanced. In a sense, this constraint is also an objective, since a continuous deficit as well as a continuous surplus can impose an inequitable burden on other countries.

These objectives can conflict among themselves as well as with some of the primary objectives (e.g., full employment); and when they do, they can only be reconciled by compromise. Opinions differ on how best to reconcile them, depending on the relative importance attached to the different objectives. Opinions also differ among nations, and this fact creates another objective: (7) the international payments system should allow

each country to seek that combination of conflicting objectives it considers best, without thereby inflicting harm on its neighbors or interfering with their pursuing their own aims. Indeed, (8) to prevent unneighborliness is another objective at which international cooperation should aim.

There are many historical examples of conflict between objectives, with countries sacrificing one or more in favor of attaining others. In the 1930's, many Central-European countries sacrificed convertibility and restricted the movement of goods and capital in order to raise employment or prevent "the importation of unemployment." Conversely, in the 1960's, U.S. employment-stimulating policies have been limited for the sake of balance-of-payments considerations. Again, the fixity of exchange rates was abandoned by Great Britain in 1931 to avoid making sterling inconvertible at fictitious rates and to ease deflationary pressure. The external value of the currency was reduced by France in 1958 in order to remove a payments deficit, and increased by West Germany and the Netherlands in 1961 in order to eliminate payments surpluses and the associated inflationary pressures.

The proposals for reforming the international monetary system currently advocated by economists also represent compromises; differences among them reflect differences in opinion on the relative importance of various aims or on the efficacy of various means. Some stress maximum protection of national sovereignty against shocks coming, or obstacles to expansion imposed, from outside; others favor cooperation among nations and, hence, mutually supporting, or at least compatible, national measures. Among the "interna-

tionists" are champions of the free-market idea who look to international cooperation as a reinforcement of their own government's weak monetary discipline.

Some favor variable exchange rates in order to assure quicker and smoother adjustment, independent national policies, and the avoidance of centralized decision-making in the monetary field; most people prefer stable, and some entirely fixed, exchange rates. Many advocate larger and growing international reserves to allow deficit countries more leeway for avoiding restriction both of domestic activity and of foreign trade. At the same time, they wish equally to avoid the inflationary pressures that too fast a growth of reserves would create. Yet another reform proposal would create groups (blocs) of countries, with variable exchange rates between the different groups but fixed exchange rates, assured by close economic cooperation, within each group.

Finally, some variants of the proposals to increase the supply of monetary reserves would put at the disposal of developing countries the real resources obtained in exchange for the additional reserves created. However, virtually any reform of the international payments system would, if successful, promote aid for development by facilitating the international transfer of funds.

CHAPTER III

MORE ON THE THREE PROBLEMS
AND ON SOME APPROACHES
TO SOLVE THEM

THE four major approaches to international monetary reform, which will be discussed in detail in the next chapter, reflect disagreements among their respective advocates about the relative importance of attaining one or another of several objectives, about the probabilities that one or another type of disturbance in international payments is likely to predominate in the future, and about the responses of national economies to different methods of adjustment. Despite these differences and the consequent preferences for different approaches, the conferees found themselves largely in agreement that whereas one approach was better suited to deal with particular problems under certain conditions another approach might be more appropriate for other problems or conditions. A few of the conferees would regard a reform that follows only one of the approaches as adequate for most situations—and would therefore rule out the other three approaches altogether; but most of the conferees visualized certain facets of several approaches—though certainly not all four of them in their entirety—as complementary, rather than alternative or mutually exclusive. The different approaches to international monetary reform thus reflect, in part at least, the variety of problems confronting the world. This fact is most clearly brought out by considering the contribution which each of the various approaches makes to

the three major problems introduced in the preceding chapter.

ADJUSTMENT

The conferees found it useful, for analytical purposes, to classify the many different possible causes of imbalance in international payments into a few major types. Having done so, they were able to trace many of their differences about the desirable speed of adjustment to differences in their appraisals of the relative frequency with which the various types of disturbance would occur in the future.

Types of Disturbance

1. The first type are disturbances that may be characterized as "continuing" or "persistent" and which arise predominantly from changes in "real" supply or demand conditions. The resulting changes in a country's receipts or payments reflect a change in its international economic position that cannot, for policy purposes, be regarded as temporary. They therefore call for offsetting changes in other components of receipts or payments. Examples of this type of disturbance are the loss of foreign-investment income after a war resulting from wartime liquidation of foreign investments, the loss of an export market owing to the technological displacement of a major export product or to a change in tastes, or other changes in comparative advantage.

The imbalances in payments arising from such disturbances cannot be financed indefinitely by the deficit country out of its own reserves, since these reserves, however large, are necessarily limited, and they will not be financed indefinitely by loans supplied directly or indirectly by surplus countries. Indeed, in the absence of visible progress in adjustment, the effects of the

original disturbance are likely to be magnified by outflows of capital from the deficit country, resulting from the belief that the value of its currency may decline. This type of disturbance requires adjustment, and the adjustment involves a reallocation of labor and capital within countries or redistribution of national expenditures, or both. Financing is also required, but only to take the country through the period of adjustment.

2. The second type of imbalance is that arising from differences in rates of monetary expansion among countries relative to the rates and patterns of their economic growth, leading to the spillover of the excess purchasing power of the faster expanding country onto foreign markets as a result of increased demand for imports, for exportable goods, and for foreign securities. This type of disturbance is similar to the first type in being continuing or persistent and in requiring adjustment either through the operation of market forces, set in motion by the international monetary mechanism, or through the effects of policy measures. It differs from the first type in not arising predominantly from (or being associated predominantly with) changes in real supply and demand conditions.

In "open" countries—especially in countries in which foreign trade is a high proportion of total production—such disturbances may be reflected primarily in payments imbalances and cause relatively little disparity between domestic prices and costs, on the one hand, and foreign prices and costs, on the other. In such cases, balance can easily be restored by eliminating the excess or deficiency in monetary expansion which caused the disturbance.

In countries that are "less open," either for reasons

of economic geography or because trade barriers are high, disturbances of this type may be reflected both in payments imbalances and in significant disparities between the general levels of domestic and foreign prices and costs. In an early phase, so long as the disturbances are reflected only in profit margins and commodity flows, and not yet in the general level of money costs, balance can still be restored—without causing unemployment—by eliminating the excess of monetary expansion in the deficit country. If the monetary expansion, however, proceeds far enough in the deficit country to be reflected in an excessive general level of money costs (especially labor costs) of a sort that cannot readily be reduced, the cost-price disparities become irreversible and may call for different kinds of adjustment measures. But to the extent that the disparities do not reflect changes in the conditions of real supply and demand, the adjustment does not call for changes in the allocation of factors of production within the partner countries. Easy financing of the resulting payments imbalance helps to perpetuate the disturbance and, at the same time, to transmit the excess purchasing power to other countries, thereby diluting its effects in the country where the disturbance originated. This, for some observers, is a powerful argument against automatic financing of payments imbalances of this type.

In the case of a less open country, the excessive monetary expansion is sometimes not widely diffused among the various sectors of its economy. To the extent that it is concentrated in a few sectors, it will be accompanied by shifts in the pattern of resource use. As a result, changes will also occur in “real” supply and demand conditions within the country, so that the disturbance

will have some of the characteristics of the first type as well as of the second. Then the conclusions reached in that case will also be applicable.

An imbalance in international payments resulting from excessive or deficient rates of monetary expansion will not necessarily be corrected by the mere passage of time, although events independent of the disturbance itself may correct it fortuitously. For this reason, financing of the imbalance is not a satisfactory substitute for adjustment, unless there happen to be reasons for expecting independent events to come to the rescue; it is rather a temporary means of tiding the country over the period of adjustment. Adjustment in this situation requires a change of exchange rates combined with elimination of the excessive monetary expansion or, in the absence of such a change, more protracted restraint of the monetary expansion (or actual contraction) in countries that have expanded excessively and/or acceleration of expansion in the countries that have expanded relatively too little.

If, in the countries with excessive expansion, moderate retardation of expansion is sufficient, a case can be made for financing, while leaving exchange rates unchanged. With adequate financing, monetary expansion need not be retarded so rapidly as to interfere with maintenance of high employment and the full potentialities of noninflationary growth. If the differential in the rate of monetary expansion has proceeded far, however, exchange-rate adjustment may be called for. Which method is to be preferred depends on the speed with which it is felt balance must be restored, on the one hand, and the importance attached to maintaining the momentum of expansion, on the other. Economic rea-

soning does not provide any obvious basis for determining that one speed of adjustment is more desirable than another. A maximum permissible period is given, nevertheless, by the ability and willingness of deficit countries to finance their deficits out of their reserves and by the willingness of surplus countries to finance them, either directly or indirectly. This maximum, of course, depends in part on the particular international monetary arrangements.

3. A third type of disturbance may be classified as "temporary" or "reversible." Disturbances of this class are likely to disappear without changes in relative costs, prices, interest rates, or other market reactions or policy measures induced by the effects of the disturbance on the monetary mechanism. One might cite, as examples, current-account deficits arising from crop failures; lags in the adaptation of a country's production to changes in tastes, provided these adaptations do not depend on the working of the balance-of-payments mechanism, but can be induced by market forces operating without changes in aggregate money demand (as, for example, in the case of the partial displacement of standard U.S. cars by small foreign cars and the subsequent introduction of compact models by the U.S. industry); accumulation or liquidation of inventories associated with cyclical fluctuation or other reversible influences; capital movements arising from temporary stimuli; widespread expectation of changes in exchange rates that do not in fact occur and whose failure to occur will reverse the capital flow; or temporary changes in interest-rate differentials resulting from differences in the timing of cyclical movements among countries.

Relative Advantages of Financing and Adjustment

The foregoing classification of disturbances provides the basis for considerable agreement about remedies appropriate in each case, even though disagreement remains about final preferences for the various reform proposals. These differences result from differing views about the *general* desirability of financing, on the one hand, and of adjustment, on the other. Differences on this issue, in turn, reflect in part—although only in part—differing views about the relative importance of major objectives of policy and the probable relative importance of the different types of disturbance in the future.

Reliance on financing—coupled with retardation of the operation of the adjustment mechanism or postponement of adjustment measures—tends to be favored by those who believe that the bulk of all imbalances in the future will be due to temporary or reversible disturbances (so that adjustments in relative cost-price relations and in resource allocation would be wasteful). But some also prefer prolonged financing in the case of persistent or nonreversible disturbances because they believe that quick adjustments can be effected only by sacrificing otherwise attainable objectives of policy, such as full employment or fast growth. (Proponents of this view include economists who would agree that balance in international payments can be restored quickly by changes in exchange rates but who believe that fixity in these rates is itself a condition for attainment of other objectives.) Delay of adjustment is also favored by some on the ground that, in reality, the basic cause of any given imbalance cannot easily be identified when it occurs and that time must elapse, therefore, before the most appropriate remedy can be selected.

Others believe that official financing of imbalances is either unnecessary or undesirable. Thus, the proponents of continuously flexible exchange rates believe financing by official reserves is unnecessary because flexibility of exchange rates introduces an element of cushioning by means of private short-term capital movements and thereby permits gradual adjustment without undue sacrifice of other policy objectives.

Advocates of a semiautomatic gold standard regard prolonged financing as undesirable because they believe that, in practice, it leads not to gradual adjustment but to postponement of adjustment. Indeed, they fear that financing, coupled with offsetting the effects on the domestic money supply, may permit the imbalances to grow and reach a point where the only possible remedies involve greater interference with other policy objectives than would have occurred had the adjustment been initiated promptly and taken the form they advocate. This school, in other words, sees the existence of large and readily available means of external financing as removing a discipline which they regard as desirable. In general, proponents of this view believe that the most probable future cause of imbalance is excessive monetary expansion in some countries. They also tend to fear price inflation more than they fear failure to attain high employment and an accelerated rate of economic growth, either because of different priorities they assign to alternative objectives or because of different assumptions they make about the best ways of achieving these objectives. Moreover, perhaps because they do not believe that restraint of monetary expansion is likely to defeat other policy objectives in the long run, they are

less concerned with whether a given imbalance is of one or another of the three types identified above.

An important element in the opposition to larger provision for financing is the fear that the mere existence of large owned reserves or borrowing facilities would give rise to the danger of excessive monetary expansion in the world as a whole. This danger arises, in their opinion, through the combination of the effects of large international reserves on domestic monetary expansion and the unwillingness or inability of national monetary authorities to break the link between international reserves and supplies of domestic money and near-money.

It appears that—apart from the proponents of a semi-automatic gold standard and of freely flexible (unmanaged) exchange rates, who believe that imbalances should be corrected quickly irrespective of their cause—the conferees share a considerable measure of agreement as to the remedies appropriate to particular causes of imbalance. In their view, the fact that different diseases call for different cures increases the importance of diagnosis and of finding means of keeping different methods of adjustment available.

The conferees agreed that diagnosis is difficult and highly uncertain. Indeed, some of those who favor flexibility of exchange rates believe that it is hardly possible to diagnose correctly the various types of disturbances at a sufficiently early stage and that irreversible mistakes will be made too often if the authorities attempt to determine on an *ad hoc* basis whether prolonged financing or prompt adjustment is appropriate. These conferees contrast the danger of error with the smoothness and the easy reversibility of adjustment under a properly conducted system of floating rates.

The effect of exchange-rate movements is to change relative costs and prices and thereby induce the appropriate reallocation of productive resources while maintaining aggregate effective demand at levels consistent with high employment and price stability. Proponents of flexible rates recognize the danger that exchange-rate depreciation in response to a temporary disturbance might set in motion forces, partly political, that lead to an undesired rise in the general national price level and might induce unnecessary shifts in the allocation of labor and capital. They believe, however, that these dangers could be taken into account by internal monetary policy. Assuming that full employment prevailed, the appropriate initial response of the monetary authorities to a disturbance tending to cause depreciation would be to tighten credit and cushion the original tendency toward depreciation in order to avoid a strong updrift of prices and a pressure for a shift of labor and capital that might prove excessive. If the disturbance did prove to be temporary, the monetary restriction could be stopped as the downward tendency of the exchange rate ended and was replaced by a movement back to its original level. If the disturbance persisted, the restriction could be eased sufficiently to allow whatever further depreciation of the currency was necessary to combine external balance with reasonably full employment and stable prices.

Judicious use of monetary policy can thus, in their view, gradually secure internal as well as external balance through a variety of mechanisms, obviating the need for immediate diagnosis of the causes of disturbance and making possible a quick reversal of policy if the causes prove to be transitory. At the same time, they

say, the immediate use of monetary policy to counteract a disturbance minimizes the danger that an inflationary trend will gather momentum, a danger likely to be increased if official financing is used to bridge payments imbalances.

Those who believe that enduring disturbances involving changes in real conditions of supply and demand are likely to be important in the future recognize the ease with which the adjustment process can be set in motion under a regime of flexible exchange rates, but they stress that this ease does not avoid (possibly painful) changes in the pattern of production. They note that changes of exchange rates alter the relation between prices and costs in industries producing exportable and import-competing goods, on the one hand, and in purely domestic industries, on the other, and therefore create market incentives for shifts in the allocation of labor and capital between these two types of industries, whether or not the disturbance creating the exchange-rate movement calls for such shifts. They point out that, if the disturbance proves not to require such shifts, waste can be avoided by not initiating them, whereas if it does prove to require them, little will have been lost, in their opinion, by allowing more time for restoration of balance.

The fact that diagnosis is uncertain also forces us to recognize another question—one faced by all who must make decisions in the face of uncertainty. What is the cost of being wrong? The question of whether a given imbalance, when it occurs, should be dealt with by a rapid adjustment, a slow adjustment, or none at all, must then be reformulated as follows: What are the costs and benefits involved in initiating a process of

adjustment that may turn out to be premature or entirely unnecessary, as compared with the costs and benefits of delaying or failing to initiate one that may prove to be necessary? The advocates of a semiautomatic gold standard and of flexible exchange rates tend to stress the costs of delaying adjustment, while the other conferees, as already noted, tend to stress the costs of rapid adjustment or of prompt initiation of it when it may turn out to be unnecessary.

The sources of disagreement on this point—assuming that diagnosis of the causes of imbalance remains difficult and uncertain—lie evidently in the factual judgment regarding the relative frequency with which the various types of disturbance are likely to occur in the future and in the appraisal of the costs and benefits resulting from risking incorrect courses of action.

LIQUIDITY

The Adequacy of Reserves

Differences of opinion exist as to the degree of adequacy or inadequacy in the supply of international monetary reserves at the present time and in the recent past. The conferees, nevertheless, agree that the present system of providing for the growth of reserves gives no assurance that future changes in the supply of reserves will be appropriately adjusted to the needs of an expanding world economy based on liberal trading principles.

The growth of reserves under present arrangements has depended essentially upon the uncertainties of Western gold production, Russian gold sales to the West, private hoarding demands, unpredictable developments in the balances of payments of the United States and the United Kingdom, the continued willingness of mone-

tary authorities to accumulate and hold dollars and sterling, and periodic agreements to enlarge I.M.F. quotas. These sources of reserves and borrowing facilities have been supplemented lately by a series of bilateral stand-by credit agreements, by the General Arrangements to Borrow, and by *ad hoc* bilateral borrowing arrangements which, however useful they might be in meeting short-lived runs on currencies that threaten the continued existence of the present system, provide no solid or dependable foundation for adjusting the over-all supply of reserves to the long-term requirements of an expanding world economy.

The rate of growth of reserves must not be so low as to exert deflationary pressures on the world economy—though most believe this has not occurred in the postwar period—or to induce general resort to restrictionist pressures on world trade and payments; and it must not be so high as to encourage world inflation or to reduce the incentive for deficit countries to take appropriate adjustment measures. But the “correct” rate of growth of reserves cannot be related in any mechanical way to the growth of world trade and payments or world production. It will depend, among other things, upon such factors as the magnitude of balance-of-payments swings, the speed and effectiveness of adjustment processes and policies—whatever their precise form—and the distribution and composition of world reserves. While the exact rate of needed increase in international reserves cannot be specified, the conferees agree that, if a system of relatively fixed exchange rates is to be maintained in the future, a more dependable method, and perhaps more conscious control, of reserve creation than now exist will be needed.

Alternative Solutions

Except for a system of unlimited, unmanaged flexibility in exchange rates, under which there would be no need for official monetary reserves or for their expansion, the liquidity problem is a meaningful one for all systems of international monetary organization. Indeed, one of the main distinguishing features of most plans for international monetary reform is their particular approach to the problem of creation or provision of reserves.

One extreme approach to the liquidity problem, favored by at least two members of our Study Group, would be the adoption of a semiautomatic gold standard under which all credit reserves would be eliminated and the whole process of international reserve creation would be made dependent upon gold production and such other gold supplies as might be made available to the monetary authorities of the West. There would be a once-and-for-all increase in the world price of gold, by about 100 per cent, so as to enable the two reserve-currency countries to pay off their liabilities which constitute the reserves of foreign monetary authorities, and to increase the value of new gold production to an extent believed sufficient by the proponents of this plan to provide an adequate rate of growth of reserves in the future. Any deficiency (excess) of gold production in relation to the requirements of noninflationary growth would, so it is argued, be corrected by market forces: as general prices and costs fall (rise) because of deficient (excessive) accretions to the monetary gold stock, production of gold would become more (less) profitable and would increase (decrease) accordingly. This view, however, was widely challenged by other conferees.

Proposals for flexible exchange rates have not been specifically directed to the problem of reserve provision. Indeed, in its most extreme version, the proposal would completely eliminate the need for reserves. But so long as there is some element of exchange-rate management, the availability of reserves, in one form or another, would be essential. There would similarly be a need for adjusting the aggregate supply of reserves over time to avoid excesses or deficiencies. Too little liquidity could threaten the attainment of the major objectives of intervention; while too much liquidity could, on the other hand, increase the likelihood of monetary authorities working at cross-purposes in their exchange-rate policies. Some of the conferees believe, in contrast to the more usual view, that under a system of officially managed flexible rates the authorities would actually have to intervene in the market to a greater extent than they would under a fixed-rate system and that, consequently, the amount of reserves needed would be greater. They thus insist that a managed flexible-rate system should not be regarded as an alternative to an enlargement of international reserves.

Except for supporters of a semiautomatic gold standard, all members of the group consider it necessary to use "credit reserves" as a supplement to or substitute for gold reserves, to introduce some measure of stability in the composition of international reserves, and to try to adjust the rate of growth of total reserves to the needs of an expanding world economy. But differences of opinion prevail as to the most appropriate reserve mix and reserve-providing machinery.

Under the plan for centralization of international reserves—in its pure form—credit reserves would no longer

consist of national currencies but of gold-value-guaranteed sight deposits at a reorganized I.M.F. These deposits would replace present I.M.F. capital subscriptions. Members might undertake to hold an agreed proportion of their gross monetary reserves in the form of I.M.F. deposits, and these deposits would be increased (decreased) over time in accordance with the requirements of noninflationary growth in the world economy, by direct lending to (repayments by) member countries, by open-market operations, and by purchases (sales) of bonds issued by the International Bank for Reconstruction and Development.

An alternative approach, building upon existing institutions and practices, would be the adoption of a multiple-currency-reserve system. Dollars and sterling would continue as part of international reserves but would be supplemented, along with gold and unconditional drawing rights at the I.M.F., by the use of other reserve currencies. The conferees recognize, as in the case of the centralized-reserve plan, that closely coordinated decisions by the leading monetary authorities would be required for the successful functioning of such a system.

The foregoing by no means exhaust the list of possible mechanisms to provide for long-term growth in world reserves. The plan for establishing composite-currency-reserve units, for example, would, in addition to increasing I.M.F. quotas and liberalizing access to I.M.F. resources, provide for the creation of "currency-reserve units" to be held by the leading countries in a prescribed ratio to gold. And there are many other schemes, some of which can be combined in ingenious ways. Some plans are based on automatic formulas, others on joint

decision-making. Some would prescribe gradual, evolutionary modifications of present institutions and practices; others would call for a more radical transformation of existing machinery. Some are concerned only with means for increased provision of international reserves; others are designed to attain additional objectives as well. Some would introduce a greater element of orderliness in the process of reserve creation; others would in fact, contrary to the expectations of their proponents, introduce potential new elements of instability.

A substantial number of the conferees expressed sympathy for either a centralized-reserve or multiple-currency-reserve approach to the problem of providing for a more orderly and dependable rate of growth of reserves in the future. It was recognized that the success of either approach would call for coordinated decisions by the leading monetary authorities regarding the rates of change in total reserves held by the participating countries and on the appropriate composition of these reserves, and that both approaches raised similar problems from the point of view of achieving the major objectives of international monetary reform.

CONFIDENCE

Reserve Assets: Acquisition and Composition

The problem of confidence in reserve media has at least two dimensions. First, monetary authorities may wish to change the composition of their reserves by substituting one reserve asset for another. We may call this aspect the problem of asset composition. Second, monetary authorities may not wish to take up more of a particular asset than they already hold and may seek to convert the additional amounts acquired in the course

of intervention in the foreign-exchange market. We may call this aspect the problem of asset acquisition.

The nature of the first problem can be vividly illustrated: Suppose that a major central bank were to present its large dollar claims for conversion into gold, which it might do for economic or financial reasons or, possibly, for political purposes. The reduction of U.S. gold holdings on account of this one transaction might cause other holders of dollars to reexamine their positions and to run down their dollar balances as well. A succession of conversions would reduce the gross total of official reserves and would also compel the United States to take drastic action in defense of its own gold reserves. It might strive for a surplus to rebuild its reserves at the expense of other countries and by so doing would further reduce gross world reserves. Some believe, moreover, that the United States might suspend gold sales to monetary authorities at the first sign of a "run" on its gold stock. It would thereby rupture the connection between gold and the dollar in the international monetary system.

The second problem may be illustrated by another example: If there were a large sale of dollars or sterling by private holders, foreign or domestic, foreign monetary authorities would come into possession of additional dollars. They might not want to hold more dollars or sterling and would then present them for conversion into gold. This, too, could touch off a "run" on the gold stock of the United States (or the United Kingdom) as, after the decline in the U.S. (or U.K.) gold stock, monetary authorities might no longer want to retain the dollars or sterling they had previously been willing to hold. In the absence of sudden changes in confidence,

the system may still be damaged by what happens "at the margin." Under the existing gold-exchange standard, the world has relied on a growth in dollar holdings for much of the increase in reserves. This same growth tends to impair the reserve position of the United States, increasing its short-term liabilities relative to its own reserves. An increase in the quantity of international reserves may consequently lead to a decline in their quality, as viewed by the monetary authorities holding these reserves.

Solutions to the Problem of Acquisition

Many conferees are persuaded that the problem of asset acquisition requires urgent action. Their reasons, however, are various. Some of them stress the effects just described—the decline in "reserve quality" that would accompany any further increase in dollar or sterling reserves. They advocate a range of reforms designed to supply additional reserves without further impairing the net reserve positions of the existing reserve-currency countries. The proposals for centralization of international reserves seek this result by allowing the I.M.F. to create new reserve assets alongside, or in lieu of, existing currency reserves. The proposal for a multiple-currency-reserve standard also seeks this result; it would have other countries' currencies serve as reserves together with dollars and sterling so that the need for additional reserves, when manifest, could be met by countries that still have unquestioned reserve positions. Finally, some economists propose that the existing reserve-currency countries give gold-value or exchange-rate guaranties on any increase in foreign official holdings of their currencies, so that central banks may be

willing to acquire additional dollars or sterling. This proposal involves an extension of methods already employed by the United States, as it has given guaranties on certain liabilities held by other countries in connection with bilateral credit arrangements.

The advocates of freely flexible exchange rates and of a semiautomatic gold standard would also regard their proposals as solutions for the problem of asset acquisition, since neither system would permit the purchase of foreign exchange by monetary authorities. Both groups regard increased holdings of dollars or sterling (or any other currency) as undesirable, partly because such acquisitions allow the reserve-currency countries to run payments deficits for too long and thereby impose inflationary pressures on the rest of the world.

Solutions to the Problem of Composition

The problem of asset composition also commands attention and concern, but there is greater disagreement on its importance and, if important, on the best solution. Some economists deny that there is an urgent problem. They doubt that any major country would, in foreseeable circumstances, try to convert its currency balances into gold. The growth of cooperation and consultation among central banks is cited as evidence to this effect, as it implies a strong collective commitment to the stability of the international monetary system. Those who hold this view also stress the interest-income incentive to hold foreign-exchange reserves rather than gold.

Other economists believe that the problem of composition is quite urgent. Some of them, indeed, issued a statement to this effect at the end of the first Bellagio conference, calling for "consolidation" of existing for-

eign-exchange balances. They do not necessarily forecast an early and massive switch from dollars into gold, but interpret the apparent stability of reserve-asset composition rather pessimistically. Central banks, they say, have held on to their dollar balances and taken on additional holdings because they are unwilling to incur the onus of precipitating a crisis.

Yet those who agree in attaching great importance to the problem differ as to the appropriate solution. Some advocate immediate measures to remove the "overhang" of dollars and sterling, before or apart from any other reform of the international monetary system. One such proposal calls upon the reserve-currency countries to issue long-term debt instruments, not convertible into gold but bearing a gold-value guaranty, and to exchange these new certificates for the dollar assets presently held by other countries. Others propose that central banks transfer their dollar balances to the I.M.F., receiving in their place deposits with the I.M.F. that would also bear a gold-value guaranty. A third proposal suggests that, if foreign holders of dollars or sterling convert their claims into gold, the I.M.F. should extend special lines of credit to the United States and the United Kingdom, in addition to their normal drawing rights.

The several plans for general reform of the international monetary system also seek to cope with the problem of confidence. The multiple-currency-reserve proposal would make several contributions. First, it would supply central banks with a wider range of assets, permitting them to diversify their reserve portfolios and thereby rendering them less sensitive to the possibility of changes in asset quality or changes in exchange rates. Secondly, it would give them exchange-rate guaranties

on their holdings of currency reserves. Finally, it might even specify the "presumptive" or "normal" composition of official reserves, formally restricting the substitution of one asset for another. Critics of this proposal fear that strict regulation of asset composition would be unacceptable and perhaps undesirable, but they recognize that the absence of such rules might be very damaging. They believe that the very creation of additional reserve currencies would increase the scope for substitution among reserve assets and, therefore, increase the potential instability of the system.

The proposals for centralization of international reserves seek to solve the problem of confidence in various ways. First, they call for the replacement of foreign-exchange balances by deposits at the I.M.F., so that central banks could no longer convert these currencies into gold. Second, they call for minimum deposit requirements; each country might be obliged to hold some fixed minimum of its total reserves in the form of I.M.F. deposits. Some advocates of this arrangement believe that such minimum deposit requirements, the interest that depositors would earn, the gold-value guarantees on deposits, and the guarantees against default would combine to protect the new international reserve-creating institution against a "run" on its own gold holdings. (In their view, central banks would even prefer I.M.F. deposits to gold.) Others, however, though favoring the basic plan, doubt that these provisions would solve the problem of confidence. They propose that the new central-reserve institution (I.M.F.) be spared any obligation to pay out gold, so that there could be no substitution of gold for deposits. Some would prefer that this be done from the start, but consider it more practical to

proceed gradually, limiting conversion step by step, for example, by raising the minimum deposit requirements at the central-reserve institution.

The proposal for a semiautomatic gold standard also seeks to solve the problem of confidence by eliminating all possibilities of substitution between reserve media. It envisages a once-for-all increase in the price of gold that would permit the existing reserve-currency countries to pay off their obligations to other monetary authorities. It would then forbid monetary authorities to hold any international asset except gold. Once existing currency balances were liquidated, the monetary system would be safe from crises of confidence stemming from shifts in the composition of reserves. Critics of this plan, however, point to a problem which is nearly analogous to the problem of confidence described above. If private individuals came to believe that the price of gold would be increased once again, they might begin to buy gold and drain reserves from all the central banks. Doing so, moreover, they might accomplish the very result they had anticipated. Central banks would be compelled to allow a decline in the supply of money as their gold stocks fell, and this would depress world prices relative to the price of gold. Critics believe that gold production might not respond sufficiently to changes in general price levels so that changes in expectations about the price of gold or the general price level would have a deleterious effect on world reserves and the world economy.

The proposals for flexible exchange rates are not directly designed to cope with the problem of confidence, but have important implications for it. The proposal for unlimited, unmanaged flexibility would do away with

the need for reserves and, therefore, with the confidence problem as it has been defined here. Under this plan, however, there may be an analogous problem. Some economists believe that unlimited flexibility of exchange rates might invite large destabilizing movements of private short-term capital. These could have powerful effects on the exchange rates, affecting prices and the allocation of resources. If these seemed likely, monetary authorities might not be willing to forego intervention in the foreign-exchange market and would then have to hold reserves. In this case the problem of confidence in reserve media might exist even under flexible exchange rates. Some advocates of limited or managed flexibility, consequently, favor centralization of reserves or the widespread use of exchange-rate guaranties. They view these proposals as complementary to their plans for flexible exchange rates.

CHAPTER IV

ASSUMPTIONS UNDERLYING THE PROPOSED APPROACHES

ADVOCACY implies criticism. One cannot reasonably recommend a plan or approach without implying that it is in some respects better than what we now have and what others recommend. Hence, a statement of the assumptions which underlie the recommendation of any plan or approach must include critical propositions about both the present system and alternative approaches. These critical propositions, of course, are accepted by some, and rejected by others. Since none of the conferees preferred the present system to all proposed alternatives, no statement of propositions supporting its maintenance was prepared. In order to avoid, however, an impression of exaggerated hostility toward the present international monetary arrangements, or of a failure to appreciate their historical contributions, it was decided to have a brief commentary on the present system precede the statements of assumptions underlying the proposed alternatives.

PRESENT INTERNATIONAL MONETARY ARRANGEMENTS

The present international monetary mechanism is not a simple and logical "system." Rather, it is a set of arrangements which is the composite result of agreements, compromises among conflicting interests and opinions, adaptations to unforeseen developments in the evolution of world trade and finance, and precedents that grew out of *ad hoc* arrangements or individual

policy decisions. As such, it represents a mixture of different techniques evolved to carry out different principles, of policies which sometimes follow given principles and sometimes contravene them, and of mechanisms which probably would be common, in greater or lesser degree, to any system.

The present set of arrangements originated from the determination of the nations of the world to prevent a repetition of the disorders of the 1920's and 1930's. The basic instrument of this effort was the provision of international monetary reserves and borrowing facilities intended to permit nations to avoid pressures for harmful monetary contraction and competitive depreciation of foreign-exchange rates and to aid them in eliminating exchange restrictions and reducing barriers to trade. These efforts were largely successful. Under the postwar system bilateralism was generally eliminated, an environment was created in which world trade and production expanded at an unprecedented rate and, at long last, convertibility of currencies was restored.

In the monetary field, these efforts centered around the International Monetary Fund, which for a period was supplemented by the European Payments Union. The I.M.F. is a supplier of currencies subscribed by its members and also a regulatory and advisory agency. Both the contributions and the rights of member countries to draw foreign currencies are related to their quotas, which have been increased from time to time in a generally uniform way.

The key feature of the present monetary mechanism, however, is the use of gold and a few national currencies—mainly the U.S. dollar and British pound sterling—as international monetary reserves, and the increasing

role of these currencies in the total of such reserves. It is thus usually referred to as a gold-exchange standard. These two elements of reserves are supplemented by drawing rights on the I.M.F. and are further buttressed by a complex set of arrangements, including the General Arrangements to Borrow, the Basle Agreements, and various bilateral swap and borrowing arrangements.

The postwar movement towards loosening of controls, liberalization of international trade and payments, and increased international cooperation in national policies that has taken place under these monetary arrangements has been highly beneficial to the world, in the general view of the present conferees. The conferees also agree, however, that in part precisely because of the increase in international trade and investment which has occurred under these arrangements, the latter are becoming increasingly inadequate.

Despite agreement among the Group on this general conclusion, the members differ about the reasons for their dissatisfaction with the present system and about the ways in which they find it wanting.

At the level of principles, some consider it too rigid, because they regard its provisions for supplying monetary reserves as inadequate or because it presumes that exchange rates will remain fixed under normal circumstances. Others consider it too loose, because it allows delay in initiating adjustment processes in the face of imbalances in international payments. They believe such delays are likely to compound or aggravate the difficulties of future adjustment.

At the level of operations, some may criticize the way in which the I.M.F.'s resources are replenished or its drawing facilities are provided; or the type of agree-

ments by which additional resources are obtained, either in general or for the support of reserve currencies.

At the level of general effects, the criticisms address themselves either to the policies which the international monetary arrangements have imposed or to those which they have been unable to prevent.

Despite such differences, there is general agreement among the members of the Group that the liquidity-creating mechanism of the system is inefficient.

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SPELLING OUT THE ASSUMPTIONS

The lists of propositions which, if accepted as pertinent, correct, and realistic, would justify the adoption of a particular system, cover essentially three questions: A. In what respects are the present-day system and the three other proposed systems inferior to the one under consideration? B. What are the essential arrangements which characterize the system? C. What are some of the necessary conditions for the system to work in the intended fashion?

The statements answering these questions were formulated from the point of view of one who advocated the system in question. This does not mean that one who rejected a single proposition—say, because he regarded it as unrealistic—necessarily rejected the entire system; he could find the proposition irrelevant or, at least, not critically important, so that its being unrealistic would not matter. Yet, the conferees considered most of the assumptions included in the statements significant enough to matter in a decision, positive or negative, about the system in question.

The lists of assumptions or propositions concerning the four systems are uniformly organized under headings roughly corresponding to the questions posed above.

The heading of Part A is "Criticisms of the Present and Alternative Systems." There is duplication whenever the advocates of different approaches raise the same objections to the present system or to some of its alternatives. There are, on the other hand, many significant differences in the critical propositions, which make it worthwhile to spell them out. Questionnaires were designed both to test the appropriate formulation of each proposition and to find out the position of each conferee regarding each proposition. The questionnaires became increasingly sophisticated as the analysis proceeded. Starting from simple "true or false" checks, the checklist had to resort eventually to a triple-valued logic. The respondent had to answer, first, whether or not he accepted the stated proposition as "valid as a description" of the present or alternative arrangements; if yes, whether or not he accepted it as "valid as an objection" to these arrangements; and if yes again, whether or not he accepted it as "valid as an argument" in favor of the system under consideration. Needless to say, the number of affirmative replies decreased from column to column, though it remained high on some propositions. Advocacy of the system in question presupposed affirmative replies in all three columns.

The heading of the propositions of Part B is "Institutional Arrangements under the Proposed System." Regarding this group, the concern of the conferees was twofold: whether or not the propositions provided a fair description of the most characteristic features of the system and, secondly, whether the conferees regarded the described arrangements as "acceptable by major countries." The latter question called for political judgment rather than economic analysis; moreover, since the time and circumstances in which decisions were to be made were not specified in the questionnaires, replies

were not comparable. Some conferees would consider an institutional arrangement "acceptable," but add "in five years from now" as an explicit or mental reservation; others would check "not acceptable," thinking only of today's attitudes, and would advocate another approach as their second-best, but more readily obtainable, solution.

Part C contains the assumptions with respect to the "Operation and Implications of the Proposed System." These are mainly assumptions concerning the future; they include extrapolations and projections of past reactions ("behavior functions"), predictions of events or conditions regarded as probable for a variety of stated or statable reasons, and sheer forecasts based on "insights" of several unspecified kinds. The questionnaires completed by the conferees asked whether each assumption was or was not "likely to be satisfied by actual conditions if the arrangements proposed in Part B were accepted by major countries." The conferees agreed that the more fully the assumptions stated in Part C were satisfied, the better would be the chance for the approach in question to work in the intended fashion.

Part D collects arguments and descriptions concerning variants of the system under consideration, under the heading "Arguments for Modification of the System." For example, while the ideal type chosen for Centralization of International Reserves prohibits the direct holding of foreign-exchange reserves by the monetary authorities of the major countries, a variant discussed in Part D allows such reserves to be held along with deposits in the central-reserve institution. Likewise, the "Composite-Currency-Reserve Plan" is treated as a modification of the Multiple-Currency-Reserve System; and various combinations of "limited" flexibility and "managed" flexibility are discussed as modifications of the

pure form of (unlimited, unmanaged) flexibility of exchange rates. The statements of Part D differ from all the others in that they omit detailed sets of assumptions on the basis of which the variants in question could be supported. Limitations of time and patience are responsible for this deviation. The bunching of critical, descriptive, and operative propositions in single paragraphs made it impossible to test them by means of the questionnaire method used in testing the assumptions concerning the pure form of each system.

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CENTRALIZATION OF INTERNATIONAL RESERVES

PART A. Criticisms of the Present or Alternative Systems

1. The present system, which relies on the deficits of reserve-currency countries to supplement the growth of monetary gold reserves, cannot continue indefinitely; since the system necessitates a progressive increase in the ratio of liquid liabilities of the reserve-currency countries to their gold holdings, it creates a growing threat to the value of the reserve holdings of other countries, with the result that confidence in the stability of the system is undermined.

2. The evolution of reserves to be expected from current gold production at the current gold price and from deficits of the present reserve-currency countries is haphazard and does not ensure that changes of world reserves over time are neither excessive nor deficient.

3. Under existing and foreseeable circumstances, the adjustment mechanism will too often fail to work fast enough to enable countries to finance their deficits with the international reserves and borrowing facilities that are available. In the absence of adequate reserves and borrowing facilities, it will be impossible to reconcile

satisfactory growth of world trade and capital movements with the maintenance of reasonably full employment and stable prices.

4. The use of national currencies as international reserves of national monetary authorities creates one of the main difficulties interfering with parity adjustments by the reserve-currency countries when needed.

5. The instability of the present currency-reserve system is due to the use of national currencies as international reserves; the instability could be removed by substituting for the reserve currencies claims against an international institution (a reformed I.M.F.). This system would facilitate adjustment of payments imbalances by means of changes in exchange rates, since a devaluing country would be obliged automatically to compensate the international institution for the reduction in the value of the latter's holdings of its currency, whereas under the present system the absence of agreed compensation arrangements inhibits change in the exchange values of the reserve currencies. Moreover, the growth of international reserves required to sustain the growth of world trade and payments could be provided by steady expansion of the liabilities of the international reserve institution.

6. Alternative systems either would not meet the basic criticisms stated above or they would offer less desirable or less practical solutions:

- (a) A semiautomatic gold standard would leave the evolution of world reserves to the haphazardness of gold production, private gold hoarding, and U.S.S.R. gold sales and would not ensure that changes in world reserves over time be neither excessive nor deficient.
- (b) A system of multiple-currency-reserves is less stable and politically more vulnerable than centralization of

reserves in an international deposit institution. The multiple-currency-reserve system, specifically,

- (i) would not, in fact, avoid complex negotiations, and the difficulties of reaching agreement and of making occasional exceptions would be no greater (and could be substantially less) among national representatives on the board of a reserve-deposit center than among the same representatives meeting in continuous consultation;
 - (ii) would not ensure that as wide a range of assets would be held by individual monetary authorities as could be held by the reserve-deposit center, since the former would probably confine their holdings to major currencies;
 - (iii) would prove cumbersome, as it would require frequent transfers of credit-reserve assets among individual monetary authorities; and
 - (iv) would raise more obstacles to extending the gold-value guaranties necessary for the full acceptability of credit reserves by monetary authorities.
- (c) Supplementation of gold by new currency-reserve units would raise problems, similar to those raised by a multiple-currency-reserve system, with respect to negotiations and would not eliminate (and might even augment) the deficiencies of the present system that result from dependence on the vagaries of gold supply and the use of major national currencies as international reserves.
- (d) A system of flexible exchange rates, while potentially useful in certain circumstances (depending upon considerations of size and openness of the countries concerned and of factor mobility, price flexibility, etc.) would not provide a satisfactory international monetary system. Specifically,
- (i) under freely floating exchange rates, expan-

sionary mistakes in the conduct of monetary policy (a major cause of payments imbalances) would lead to a rise in the price of foreign currencies, and hence in import prices, in advance of any rise in domestic prices; the mistakes would then be sanctioned by wage increases and the full force of the error would be reflected in domestic price and cost levels;

(ii) with no downward flexibility of wages and prices, expansionary and contractionary mistakes would not cancel out over time but would lead to ratchet-type inflationary effects;

(iii) pressures would inevitably be placed on the monetary authorities to interfere with the functioning of the market mechanism;

(iv) to the extent that monetary authorities insisted on managing the exchange rate, difficult management problems would be created and interventions at cross-purposes would be likely; and

(v) flexible exchange rates would encourage governments to pursue nationalistic monetary policies and would discourage potentially beneficial harmonization of domestic policies.

PART B. Institutional Arrangements under the Proposed System

7. Each country, or at least each major reserve holder, agrees to keep a fixed proportion of its gross international reserves in the form of gold-value-guaranteed sight deposits with the I.M.F. (or another international reserve center).

8. Ultimately, this should eliminate reserves in the form of foreign exchange, except working balances.

9. Ultimately, too, official reserves held in gold might

also be converted into I.M.F. deposits.

10. Acceptance of the Fund's deposit liabilities as international reserve money takes the place of the present capital subscription to the I.M.F. as the way to feed the Fund's lending power.

11. The acquisition of assets, and consequent creation of deposit liabilities, by the Fund aim at adjusting the world reserve pool to the requirements of noninflationary growth in the world economy, and at eliminating the haphazardness and instability of the present process of aggregate reserve creation.

PART C. Operation and Implications of the Proposed System

12. The I.M.F. will be able to induce member countries to hold deposits with it either by agreement or through the payment of interest and the offer of guaranties against exchange-rate changes and default. The I.M.F. will be able to increase or decrease the volume of world reserves by expanding or contracting the volume of its assets through

- (a) open-market operations in the member countries with the consent of their monetary authorities,
- (b) direct lending to member countries, provided the I.M.F. is satisfied that appropriate domestic policies are being followed,
- (c) modest overdraft facilities limited in size and duration, and
- (d) purchases of bonds issued by the International Bank for Reconstruction and Development.

13. The indirect participation in development financing, as implied by proposition 12 (d), will not impair confidence in the institution's deposit liabilities nor impede its operations.

14. Criteria and procedures can be developed and implemented to regulate the growth of world reserves in a

way that avoids both world inflation and deflation, so far as such inflation and deflation are due, respectively, to excesses and deficiencies in world reserves—that is, the volume as well as the allocation of the resources of the I.M.F. will be decided not automatically but in relation to current conditions.

15. Imbalances of payments of the present reserve-currency countries will tend to be less disturbing under a system in which foreign currencies are not held as reserves of national monetary authorities, because the possibility of disequilibrating currency speculation and sudden liquidation of official balances will be reduced.

16. The creation of reserves by an international agency will not impede desirable balance-of-payments adjustments through appropriate domestic policies or through changes of exchange rates, and may even promote such adjustment; in particular, the use of the lending power associated with the creation of credit reserves will mainly be made conditional upon the adoption of appropriate adjustment policies by the debtor countries.

PART D. Arguments for Modification of the System

1. PARTIAL CENTRALIZATION OF RESERVES, AUTOMATIC CREDIT LINES

Concern that the management of the expanded I.M.F. would be too conservative argues for two major changes: (1) that the new reserve media should, for the most part, supplement and not replace existing forms of reserves, and (2) that they should be available automatically to avoid undue interference with the freedom of domestic policies. Thus, no gold or foreign exchange would initially be surrendered for the new international deposits. These would be newly created in place of

existing drawing rights in the I.M.F., and in larger amounts. Access to these deposits would be automatic, in the same way as access to the present "gold tranche" of the quotas. The deposits could be drawn on directly by central banks for payments to other central banks; the I.M.F. would no longer sell separate national currencies. The deposits would be increased annually by an automatic formula; e.g., related to the growth in world trade or production. Existing holdings of foreign-exchange reserves would not be automatically converted into I.M.F. deposits, but only if and as these balances were liquidated in the markets and replaced by gold and thus were causing uncomfortable pressure on the reserve currencies.

2. OTHER INTERNATIONAL CREDIT SCHEMES

Full or partial centralization of reserves may be desirable ultimately, but is neither practicable nor negotiable immediately. Consequently one or more of the following schemes (or combinations of elements from these proposals) should be introduced:

(a) *Replacement of National Currencies in the I.M.F.*

The granting of Fund credits in national currencies has no sound economic basis and unnecessarily limits its willingness and ability to grant credits. Transformation of drawing rights into transferable deposits would ensure that the real burden of Fund credits fell on the creditor countries and not on those whose currencies happen to be chosen.

(b) *Voluntary Deposits at the I.M.F.* These deposits would be created by voluntary transfer into the Fund of gold or foreign exchange. They would be fully transferable, carry a gold guaranty, and bear interest

at a modest rate. The national-currency balances thereby acquired by the Fund would be liquidated as and when they were in demand by other members, that is, when the reserve-currency countries' payments were in surplus.

(c) *Special Development Certificates.* As special support for development aid, the I.M.F. should each year create a predetermined amount of special certificates. These certificates would be given to the International Development Association, which would grant them as loans to its "Part II" members on normal lending terms. The certificates would then be accepted in settlement by all I.M.F. members, who would add them to their reserves but could not convert them into gold. Membership in such a scheme would be voluntary.

(d) *Deposits of Portions of Aid or Loans Received.* An alternative way of ensuring that aid and loan funds do not cause strain on the donors' payments balances is for a small fixed portion of such funds to be deposited by the recipients in special loan accounts at the I.M.F.; and for these to be drawn on for all expenditures out of such loans to third countries. Countries receiving such deposits in payment for goods and services would be able to transfer these loan deposits for their own settlement, but could not convert them into gold. These "loan deposits" would be liquidated when the loans in question were repaid.

(e) *Regional Centralization of Reserves.* Alternatives to the schemes for world centralization of reserves are possible in the form of regional variants, which might themselves be linked in a decentralized worldwide system.

MULTIPLE CURRENCY RESERVES

PART A. Criticisms of the Present or Alternative Systems

1. The present system, which relies on the deficits of one or two reserve-currency countries to supplement the growth of monetary gold reserves, cannot continue indefinitely; since the system necessitates a progressive increase in the ratio of liquid liabilities of the reserve-currency countries to their gold holdings, it creates a growing threat to the value of the reserve holdings of other countries, with the result that confidence in the stability of the system is undermined.

2. The evolution of reserves to be expected from current gold production at the current gold price and from deficits of the present reserve-currency countries is haphazard and does not ensure that changes of world reserves over time is neither excessive nor deficient.

3. Under existing and foreseeable circumstances, the adjustment mechanism will too often fail to work fast enough to enable countries to finance their deficits with the international reserves and borrowing facilities that are available. In the absence of adequate reserves and borrowing facilities, it will be impossible to reconcile satisfactory growth of world trade and capital movements with the maintenance of reasonably full employment and stable prices.

4. The instability of the present currency-reserve system, which is largely due to its concentration on one or at most two reserve currencies, can be most easily eliminated by the establishment of a multiple-currency-reserve system, as described below. The same system can provide for the growth of reserves and borrowing facilities on the scale required to permit balance-of-

payments adjustment at a pace consistent with maintenance of reasonably full employment and stable prices in a liberal international economic order based on fixed exchange rates.

5. Alternative systems either would not meet the basic criticisms stated above or they would offer less desirable or less practical solutions under present conditions:

(a) A semiautomatic gold standard leaves the evolution of world reserves to the haphazardness of gold production, private gold hoarding, and U.S.S.R. gold sales and would not ensure that changes in world reserves over time will be neither excessive nor deficient; the rate of increase in reserves must be managed by international agreement in the light of prevailing circumstances.

(b) A system of centralization of reserves at an international deposit institution

(i) would not be accepted, at least at this time, by the major industrial nations;

(ii) would necessitate determining from the start formal rules for the distribution of voting power among the participating countries, which would be difficult to negotiate and might have far-reaching political consequences;

(iii) would not permit the gradual development of informal procedures for reaching consensus among groups that have a tradition of cooperating; and

(iv) would not allow, on occasion, an individual country to go its own way.

(c) A system of flexible exchange rates

(i) is anathema to businessmen and bankers and, although preferred (chiefly in the form of flexibility within limits) by several advocates of the multiple-

currency-reserve system, has little or no chance of adoption;

(ii) would remove the anti-inflationary anchor provided by the discipline implied in the fear of dwindling reserves, and would therefore allow cumulative upward trends in prices;

(iii) would lead to difficult management problems and intervention at cross-purposes if the rates were allowed to be managed by the monetary authorities; and

(iv) would force adjustment to take place more rapidly than is desirable from the point of view of economic stability.

PART B. Institutional Arrangements under the Proposed System

6. The monetary authorities of the major countries agree to diversify gradually their foreign-exchange holdings, so that the expansion of their reserves will take the form of acquiring a mixture of currencies and gold, not merely gold, dollars, and sterling.

7. The monetary authorities of the major countries whose currencies are to be held as reserves undertake to buy and sell gold freely from and to one another, to supply short-term credit instruments suitable for purchase by other monetary authorities, and to provide a gold-value guaranty on foreign official holdings of their liabilities.

8. The monetary authorities of the major countries coordinate their policies to ensure that no abrupt and destabilizing changes are made in the composition of their reserve holdings, and also undertake to raise the foreign-exchange component of their reserves when there

is general agreement that such a change is needed in order to alter the growth rate of gross reserves relative to the growth rate of monetary gold stocks. This requires that the major countries agree

- (a) to maintain in their foreign reserves a portfolio of foreign exchange which stays within a minimum and a maximum ratio to their holdings of gold,
- (b) to alter these ratios whenever there is general agreement that a change is needed to influence the growth rate of gross reserves,
- (c) to diversify their foreign-exchange portfolios among a wide range of reserve currencies, and
- (d) to avoid making abrupt changes in the composition of their portfolios by switching from one currency to another.

9. The major countries agree to acquire the currencies of the other major countries that are running payments deficits, and trust that cooperation among themselves will lead to mutually satisfactory adjustment policies.

PART C. Operation and Implications of the Proposed System

10. The rate of increase of gross reserves needed to maintain full employment and price stability will be determined by agreement among the major countries; the arrangements proposed will ensure that this increase in gross reserves will not erode the net reserve positions of the several reserve-currency countries so rapidly as to jeopardize the system's stability within a few years.

11. The arrangements will remove the need for the major countries to govern their monetary policies with the primary objective of attracting and keeping the

funds of foreigners, private and official; these countries will, therefore, be able to coordinate their monetary policy with their other domestic policies so as to secure international adjustment at a pace consistent with other objectives of economic policy.

12. The negotiation of the requisite agreements will not divert attention from longer-run problems of international adjustment and of regulating aggregate monetary reserves, but will instead pave the way for internationally agreed solutions to these problems.

13. The decentralization of the reserve system implied by the proposal will, in fact, avoid complex international negotiations, yet will lead to reasonable consistency in the independent reserve-asset investment decisions of central banks and promote growth of gross international reserves at a rate consistent with the stable growth of world trade and payments.

PART D. Arguments for Modification of the System

COMPOSITE-CURRENCY-RESERVE UNITS

The annual increases in liabilities of the several reserve-currency countries might not be considered equally acceptable to all reserve holders. Sudden substitutions among different currency reserves would expose the system to serious instabilities. The institution of composite-currency-reserve units would avoid some of these substitutions and would ensure the absorption of all the new reserve currencies in stated proportions. The need for direct holdings of several new reserve currencies is thereby eliminated and, in addition, all previous channels for the creation of credit reserves are retained. The leading countries agree to hold the composite-currency-reserve units in a prescribed ratio to gold. The tech-

nique of creating the new reserve units consists in each country depositing agreed amounts of its own currency with the I.M.F. and receiving in exchange interest-bearing deposit credits denominated in reserve units. Each country guarantees the gold value of the I.M.F.'s holding of its currency.

THE INTERNATIONAL MONETARY SYSTEM

(By Robert Triffin, Yale University, Moorgate and Wall Street,
Special Supplement, July 1965)

I have always had my doubts about the truth of an old Latin proverb: "Bis repetita placent." The opposite English saying "Familiarity breeds contempt" is probably more realistic.

I apologize, therefore, to those of you who will find little that is really new in what I can tell you today about an old problem. I hope, however, that you will allow me to share your blame with those high officials and friends of mine who are responsible, at least in part, for the slow pace with which its solution has been gradually approached over the last 6 years of a dully repetitive debate.

The announced title of my talk "The International Monetary System" leaves me in doubt also as to whether I am expected to describe to you the present international monetary system, or the one that may emerge tomorrow from the discussions now underway in the IMF and Group of Ten. The only solution I see is to talk about both, especially since it would be impossible to talk intelligently about the second without exploring first the deficiencies of the present system which inspire the clamor for reform, and the constraints which existing institutions inevitably impose upon the shape and speed of feasible adjustments.

Prisoner of his past, man has never been fully master of his future. What will be is always influenced by what is, as much or more than by what is desirable in the abstract. Before gazing into what the international monetary system of the future could be, let us see, therefore, what it is today.

I. WHAT IT IS

I have tried to condense in three simple tables the main highlights of our present international monetary system.

The first of these tables shows, in absolute and in percentage terms, the sources which have fed international reserve increases over the last 7 years. For the world as a whole, 16 percent has come from new gold production in the West, an equal amount from Soviet gold sales in Western markets, 8 percent from international organizations, and 60 percent from fast-rising reserve balances in national currencies, overwhelmingly short-term dollar and sterling I O U's. If we add to this growing short-term indebtedness of the two reserve center countries of the system their losses of reserve assets; i.e. mostly gold, we find that their net reserve drains have fed more than three-fourths of other countries' reserve gains; i.e. seven to eight times the amounts derived from gold production in the West, three-fourths of Western gold production having been absorbed by private channels and particularly by the tripling or quadrupling of speculative gold hoarding purchases ever since the October 1960 gold flareup in the London market.

The second table illustrates the impact of these movements upon the net reserve position of the two reserve centers of the system. The United Kingdom's liabilities to foreign monetary authorities have, of course, long exceeded its gross monetary reserves, but this excess indebtedness has risen sharply in the last 2 years from \$2,800 million to \$5,100 million. As for the United States, its net reserves have fallen even more precipitously, from \$15,900 million at the end of 1957 to less than \$300 million at the end of last year and \$100 million in February of this year.

That this process cannot continue indefinitely is now universally admitted. What is not sufficiently perceived as yet is that it has already killed and buried the gold-exchange standard of yesteryears. This standard rested indeed, as its name implies, on the reserve holders' confidence in their unqualified right and ability to convert, on sight and at will, their gold-exchange balances into gold metal. This has long ceased to be true for sterling, but the restoration of sterling convertibility reopened an indirect channel from sterling to gold, via the gold-convertible dollar. This channel has now been heavily clogged, to say the least, by Mr. Roosa's success in eliciting from major central banks precarious restraints on such gold conversions, and by the opprobrium now attached to noncompliance with these voluntary restraints. Our old friend, Sir Roy Harrod, was the first to characterize these moves, many years ago, as institutionalizing the inconvertibility of the reserve currencies through gentlemen's agreements.

Such agreements and cooperation are soundly based on what has become the golden rule of international monetary behavior and the only chance of survival of our international monetary system: "Don't rock the boat in which we are all sitting." The trouble is that these gentlemen's agreements remain, as of now, threateningly precarious and short term, particularly whenever the passengers disagree stubbornly with the pilot—the United States, or the copilot, the United Kingdom—regarding the speed and direction imparted by them to the common skiff. Any passenger may take the risk of rocking the boat by trying to jump out, if he feels that it is being driven at reckless speed, in the middle of a thick fog, in a northerly direction when he wants to go south or, even worse, toward an area strewn with reefs.

The full implications of this curious breed of international monetary cooperation, however, were not fully perceived at first. They have unfortunately been thrown into a cruelly sharp light by President de Gaulle's speech of last February. The survival of the gold-exchange standard has now become dependent on the political willingness of foreign countries to finance, through their own monetary issues, the deficits of the countries whose national currency is accepted by them as international reserves. Compliance with such a system becomes more precarious every day, not only because the growing illiquidity of the reserve debtors throws increasing doubts upon the ultimate exchange value of such unguaranteed claims, but also because central banks are being called upon to finance debtor countries' policies in which their own governments have no voice, and with which they may profoundly disagree.

The second of the three tables distributed to you shows, for instance, that U.S. net reserve losses of \$12,400 million, over the years 1958–62,

helped finance an increase of nearly \$10,000 million in U.S. direct investments abroad. President de Gaulle objects to having his own Bank of France finance, through the accumulation of dollar I O U's, what he calls a sort of expropriation of his country's business firms. He recognizes that foreign monetary lending to the United States has also facilitated and favored * * * the multiple and considerable assistance provided by the United States to many countries for development purposes, but it is no secret that he does not particularly enjoy exposing himself to the accusation of helping finance our military assistance to Chiang Kai-shek, the escalation of the war in Vietnam, our ill-fated intervention in the Dominican Republic, etc.

This national and international politicization of the gold-exchange standard of yesteryears explains the queer and unprecedented incursion of heads of state into esoteric problems traditionally abandoned to the technical officials of their central banks and ministries of Finance. The recent summit clash between President de Gaulle and President Johnson—needless to say, the ordering of these two names is purely chronological—probably reflects a justified and growing impatience with the slow progress of these technicians in the Group of Ten negotiations, and a lurking feeling that the international monetary problem has become far too serious to be left indefinitely to monetary experts.

More than 4 years have elapsed since our regretted President Kennedy announced, in his first message to Congress on the balance of payments and gold, that he was "directing that studies to this end [of basic international monetary reform] be initiated promptly by the Secretary of the Treasury," and since your own former Prime Minister, Mr. Macmillan condemned the "unsatisfactory" nature of present monetary arrangements and pleaded for the creation of "a central banking system for all the countries of the free world." Presidents Johnson and De Gaulle, Prime Minister Wilson, former Chancellor **Mandling**, former Secretary of the U.S. Treasury, Mr. Dillon, the French Minister of Finance, Mr. Giscard d'Estaing, the Vice President of the European Economic Community's Commission, Mr. Marjolin, two successive Managing Directors of the International Monetary Fund, Mr. Jacobsson and Mr. Schweitzer, and many others, have since joined the growing chorus of the reformers.

One might have thought, last August, that they were on the verge of success, when the IMF and the Group of Ten issued two parallel reports endorsing unanimously two boldly revolutionary steps toward a fundamental reform of our international monetary machinery.

Recognizing that prospective gold production would be vastly insufficient to assure a satisfactory growth of world reserves in future years, that the pound sterling and the U.S. dollar could no longer safely fill the whole gap between available gold and legitimate reserve needs in an expanding world economy, and that the multiplication of reserve currencies was both unlikely and undesirable—as it would multiply already existing sources of instability and vulnerability of the system—they directed a Study Group on the Creation of Reserve Assets—

to investigate the problems raised by the creation and use of * * * some additional kind of reserve asset, the possible forms it might take, and the institutional aspects associated with it.

The second major conclusion of the Group of Ten was that—

the process of adjustment and the need for international liquidity are closely interrelated * * *. The need being to supply sufficient liquidity to finance temporary payments imbalances without frustrating the required process of international adjustment in individual countries, it is desirable to bring under multilateral review and appraisal the various means of financing surpluses or deficits.

Various steps are therefore recommended to provide a basis for multilateral surveillance of the various elements of liquidity creation.

The Managing Director of the IMF, Mr. Schweitzer, has repeatedly confirmed, in several speeches over the last few months, "the emerging consensus among the international community that the creation of international liquidity, like the creation of domestic liquidity, should become a matter of deliberate decision," rather than be left, as of now, to the hazards of current gold production, U.S.S.R. gold sales, speculators' gold purchases, United States balance-of-payments deficits, and uncoordinated decisions by scores of central banks regarding their future accumulation of dollars or the cashing of outstanding dollar balances into gold metal.

Each of these two major conclusions and proposals—the creation of a new type of reserve asset and the organization of multilateral surveillance of the various elements of liquidity creation—marks indeed a revolutionary break with past attitudes on the problem.

Two further points should be noted.

One is the concrete proposal of the IMF for "investment operations * * * undertaken on the initiative of the Fund, with a main purpose of creating liquidity, and not necessarily in response to a particular balance of payments need," and for the financing of such investments, at least in part, by members' liquid "deposits" with the IMF, "according to suitable criteria," and with characteristics similar to the present gold tranches, "which permit them to be considered as part of a country's reserves."

The other is the actual implementation, on an ad hoc basis, of what I described in 1959 as "the keystone" of my proposals; i.e., "the substitution of IMF balances for balances in national currencies—i.e., mostly dollars and sterling—in all member countries' monetary reserves."¹ This was done, indeed, on the occasion of each sterling crisis, the sterling balances initially acquired by central banks being in each case reimbursed a few months later by IMF drawings, and converted into equivalent increases in the creditor countries' gold tranches with the Fund. The general arrangements to borrow were essentially designed to pave the way for similar operations in the event that U.S. drawings on the IMF depleted resources in European currencies.

Over the 5 years 1960–64, about \$2.1 billion of dollar and sterling balances have been converted into IMF gold tranches by other Fund members, of which \$1.6 billion by the six countries of the European Economic Community. Such was indeed the purpose and destination of the \$1 billion drawing of the United Kingdom, last November, and of 70 percent, or more, of the new \$1.4 billion drawing of 2 weeks ago.

Such conversions of national currency reserves into true international money reserves are now undertaken only after, rather than before, the eruption of the crises triggered by the present system.

¹ Gold and the Dollar Crisis, p. 102.

They do, however, build up precedents which may later be integrated, on the basis of experience, into an institutional framework designed to prevent such crises *ex ante*, rather than to cure them *ex post*, and which would implement concretely the broad agreements of principle reached last summer by the Group of Ten and the IMF.

II. WHAT IT COULD BE

After having described what the present system is and the agreements of principle already reached about the broad direction of the reforms unanimously recognized as indispensable, let me now try to outline first the simplest and most efficient way in which these agreements could be concretely implemented. The proposals which I shall put before you may carry at times an uncomfortable aroma of wide-eyed idealism and woeful ignorance of practical, negotiating realities. But this theoretical exercise should nevertheless provide us with badly needed guidelines before we turn to the more pedestrian task of seeing how they can best be approximated in real life, by men prisoners of their past prejudices and illusions, and how they can help reconcile the various plans—academic and official—now under discussion into a workable synthesis, giving proper weight to conflicting points of view and interests.

Let me, however, first brush aside the most attractively simple plan proposed so far: that of our good friend, Mr. Rueff. Acutely aware of the mistakes that man has always made—and will continue undoubtedly to make—in his management of monetary affairs, he would boldly rule out, at least in principle, any such management altogether. Monetary reserves would be strictly confined to gold metal alone and their future growth would be abandoned to the hazards of Western gold production, of Russian gold sales to the West, and of private purchases of this fascinating metal by speculators as well as by industrial and artistic users. Mr. Rueff, however, has never been able to explain, to my own satisfaction at least, how the algebraic sum of those hazards would automatically measure the “objective needs” for world reserves.

The second—and admittedly the most difficult—problem of international monetary management is the preservation or restoration of equilibrium in each country's balance of payments. This would also be solved magically by Mr. Rueff, “in less than 3 months,” if all surpluses and deficits were immediately and religiously settled in gold, rather than financed through international credit. This “very audacious prediction” is apparently predicated, not on the discipline or policies which such a straitjacket would impose on central banks—again, Mr. Rueff has no faith in monetary management—but simply because such a form of settlement “will exert its own influence by the transfer of purchasing power which is the result of the transfer of gold.” “I have never seen,” says Mr. Rueff, “a country with a real system of international payments in which the deficit stays for more than 3 months after it has reestablished the balance of purchasing power; I mean suppressed the inflationary excesses.” I am very much afraid, however, that inflationary excesses will not be exorcised by what Mr. Rueff calls the old rule of the gold standard; that is “of creating money only against gold or bills in national currency, (but not) against any

assets in dollars.”² National currency assets of central banks have certainly been as potent an inflationary factor—to say the least—in many countries as their accumulation of dollar assets. And many countries—including France—have repeatedly experienced severe balance-of-payments difficulties over far more protracted periods than 3 months, even though they never enjoyed with the world tailors of Mr. Rueff’s parable the exorbitant privilege of paying for their deficits with their own IOU’s.

Lurking behind Mr. Rueff’s simple rule is the far more drastic, but unattainable, will-o’-the-wisp of outlawing conscious national as well as international monetary and credit management from the horizon of our central bankers. I am very much afraid, however, that these problems will not yield overnight to the magic wand of any “invisible hand” or automatic gold transfers. We may distrust the management of man over his own affairs, but neither God nor gold will manage them for him.

Finally, Mr. Rueff regretfully concedes now that his proposed reform would require a doubling of the present gold price. If, however, the gold standard could be trusted with the automatic virtues ascribed to it by Mr. Rueff, the overnight doubling of world gold reserves would certainly open the gates wide to an immediate tidal wave of inflation. What would happen after that is anybody’s guess, but only the most bizarre and haphazard coincidence between “objective needs” and the totally unrelated sources of gold supply noted above could protect the world against inflationary excesses or deflationary shortfalls.

This obvious point has, it is true, repeatedly been conceded by Mr. Rueff to his opponents. He would meet it through international agreements absorbing the gold profits of two of the more than hundred countries of the present world through gold repayments—at half of their current gold parity—of outstanding dollar and sterling debts to central banks. Other countries would presumably be expected to sterilize, also, their gold profits through the amortization of outstanding debts of their governments to their own central banks. Future excesses or shortages of gold supply in relation to noninflationary growth needs would also have to be met through deliberate tinkering by several scores of central banks with the automatism of the pure gold system.

All these agreements and deliberate decisions, however, are the very antithesis of the only virtue ascribed by Mr. Rueff himself to his system; that is, its automaticity. If such agreements are needed in any case, they can certainly be put to better uses than the digging of larger holes in the ground, in South Africa as well as in Fort Knox.

Such was, in any case, the conclusion unanimously reached and unequivocally affirmed last summer both by the Group of Ten and by the IMF report. I endorsed it in advance in my 1959 proposals for world monetary reform and see all the less reason to abandon it now as the doubling of the gold price would, in fact, penalize all those who have cooperated in making the present system work—no matter how imperfectly—and reward those who refused such cooperation and have kept, or converted, most of their reserves into gold hoards. It would

² All the above quotations are from Mr. Rueff’s special interview by the Economist of Feb. 13, pp. 662–665.

be hard to conceive of a worse preface and of a more effective deterrent to the maintenance and intensification of international cooperation which Mr. Rueff himself recognizes as indispensable to the successful implantation and smooth functioning of his own system.

Having thus neatly demolished both the gold exchange standard of yesterday and the pure gold standard of Mr. Rueff, what are we left with? "Assez taillé, mon fils, maintenant il faut recoudre!"

Let me start with a commonsense observation, which should serve as a benchmark for all practical proposals for international monetary reform:

No satisfactory outcome is possible which does not recognize * * * that the supply of reserves must be a matter of concerted international decision * * *.

I find this a particularly happy formulation, especially as it is not mine, but that of Mr. Schweitzer in a recent speech to the Economic and Social Council of the United Nations. Moreover, the principle which it expresses was unanimously, if implicitly, agreed upon last summer already by the Group of Ten, under the less happy vocable of "multilateral surveillance."

The easiest and most efficient way to implement it has also been outlined already in the last annual report of the International Monetary Fund. It is essentially identical with the double-barreled proposal for Fund deposits and investments which I outlined, many years ago, in "Gold and the Dollar Crisis."³

Investment operations * * * could be undertaken on the initiative of the Fund, with a main purpose of creating [needed] liquidity, and not necessarily in response to a particular balance-of-payments need * * *. Any acquisition of assets by investment would tend to put a strain on the Fund's resources and create a need for additional resources.

A portion, at least, of such resources—and probably a very substantial one—could be derived from the accumulation by IMF members—all, or some—of a portion of their total reserves in the form of IMF "deposits" endowed with appropriate liquidity and exchange value guarantees.

The most conservative people in this group should be reassured at once about the "revolutionary" character of this proposal. Such Fund deposits and investments would not involve "any sharp break with the past," but would, on the contrary, "build upon what already exists."

IMF deposits, endowed with full liquidity and exchange value guarantees are already accepted as a respectable component of many countries' international reserves, under the barbaric denomination of "Fund Gold Tranche Positions," recently replaced, in the Fund's literature, by the simpler and more enlightening one of "Reserve Positions in the Fund." They already reached, as of last March, the respectable total of \$4,185 million.

IMF investments, on the other hand, have also been built up already to the more modest amount of \$800 million, but have been confined so far to gold-guaranteed investments in U.S. Government securities, imaginatively undertaken under the scarce currency clause of the articles of agreement long after the dollar had ceased to be a scarce currency, for the professed purpose of increasing the Fund's earnings, rather than to increase world reserves or reduce the U.S. gold drain. Similar investments will, however, be expanded in the

³ New Haven, 1960, pp. 102-120.

near future, in order to alleviate the unfortunate impact of the increase in members' gold subscriptions on the slender gold reserves of the United States and the United Kingdom.

The further expansion of Fund's deposits and investments for the purpose of concerted reserves creation raises four major questions which I shall briefly discuss in turn:

1. What should determine the global amount of such deliberate increases of the world reserve pool?

2. Who should hold the new IMF deposits to be created, and under what conditions?

3. How should the corresponding Fund investments be distributed among members and, again, under what conditions and for what purposes?

4. Last, but not least, who shall decide?

In brief, who will decide who will lend, how much, to whom, and under what conditions?

1. The global pace of reserve growth

Whoever decides should obviously try and adjust the overall pace of reserve creation in such a way as to stimulate a maximum use of the noninflationary potential for world economic growth. This means essentially that the pace of reserve creation should be stepped up whenever recognized as necessary to combat any pervasive deflationary pressures that might arise in the world economy, and that it should be slowed down—or even reversed—in the opposite case of pervasive inflationary trends.

World trade and production have increased in postwar years—even in real terms—at unprecedentedly fast and steady paces, ranging roughly from 5 to 6 percent a year, or even more. I do not believe for an instant, however, in any rigid, mechanical connection between such economic growth rates and the need for the expansion of monetary reserves. Some of my readers seem to have been misled in this matter by the fact that, in "Gold and the Dollar Crisis," I followed, but mostly to criticize it, this Fund's approach to the problem in its 1958 study on "International Reserves and Liquidity," and suggested, as an anti-inflationary safeguard, that a presumptive ceiling be established by treaty on the annual increase of the Fund's global loans and investment portfolio, and that qualified—rather than simple majority—votes be required in order to permit increases beyond this presumptive ceiling.

2. The distribution of deposit obligations among Fund members

To be acceptable by members, as part and parcel of their international reserves, IMF deposits must be endowed with appropriate exchange-value and liquidity guarantees.

All Fund transactions are now denominated in "gold dollars," protecting them against any unilateral devaluation of the paper dollar, or indeed of any other currency. There is, therefore, no need for innovation in this respect. One might even question whether some sort of "unit of account" guarantee, patterned after that of the old EPU, or the one that will soon have to be defined by the EEC, might not meet the problem just as well, or better.

The liquidity of the Fund's deposits might best be defined in terms of their immediate and unquestioned acceptability by creditors from debtors, in all international settlements. If appropriately guaranteed

against exchange and default risks, there is no reason to think that any creditor would turn down such deposits in settlement of its claims, particularly as they should carry, in addition, some modest interest earnings. Yet, some obligation might have to be spelled out contractually in advance, until all nations become fully familiar with the system and its actual operation.

The actual composition of world reserves might be used as a guideline to determine, at each point of time, the agreements that might be needed in this respect. At the end of last year, for instance, the world reserve pool totaled about \$69 billion, of which \$41 billion was held in gold, and \$28 billion in credit reserves, i.e., in foreign exchange—primarily dollars and pounds sterling—and IMF reserve positions. In order to guard the system against a—presumably undesirable—contraction in world reserves, it might have seemed desirable therefore to require all Fund members to hold no more than 60 percent of their reserves in gold metal, and at least 40 percent in credit reserves.

In order to simplify the exposition, allow me to bypass for the moment the role of national currencies as credit reserves, and to assume that all credit reserves should be held in the form of deposits with the IMF. It would, even then, be unnecessary to impose a rigid ratio of 60-percent gold and 40-percent IMF deposits upon all Fund members, whose chosen ratio of credit reserves to total reserves varies widely, at present, from 7 or 8 percent, for instance, in the case of the United States and the United Kingdom to 85 percent in Japan.

There would be no need to interfere with each country's decision in this respect as long as the result of their combined choices remained compatible with the desired level of world reserves. If, however, these combined choices were to result in an excessive demand for a limited stock of monetary gold, enforcing thereby an undesirable contraction, or even merely an exceedingly slow growth, in world reserves, some action would have to be taken. The problem might possibly be met by an acceptable increase in the interest rate paid by the Fund on its deposits. If this were insufficient, however, it might prove necessary to enjoin the countries with the lowest percentage of IMF deposits to their total reserves from lowering it further, and even to require them to increase it.

If, on the other hand, as is far more probable in the long run, the combined decisions of reserve holders were to result in large transfers of gold to the Fund in exchange for Fund deposits, this would not create any inflationary dangers, since the Fund could merely sit on its gold holdings. Its lending potential would undoubtedly rise, but its actual use would remain limited anyway by the wisdom of the Fund's traditionally conservative management, and by the presumptive ceilings and voting rules embodied in the revised articles of agreement. Interest rates on deposits might be lowered, and—in some distant future—Fund members might even possibly give some thought as to whether the continuation of a rigidly guaranteed minimum price to gold producers and gold hoarders constitutes a boon, or a hindrance, to national and international monetary management, and promotes a wise use or a senseless waste of the world's productive resources.

They are unlikely to ask themselves this question, however, in the foreseeable future. Sterile gold hoardings may continue to be preferred by some to guaranteed and interest-earning IMF deposits, be-

cause of the fear that the most sacred treaties—including the articles of agreement of the Fund—might be jettisoned in the event of a world war. The IMF deposits might become blocked, at the most inconvenient time, for those who find themselves on the “wrong” side of the fence.

Another type of guarantee might prove useful indeed to overcome this fear, wherever it exists. Any country could request the Fund to deposit within its own territory a portion of the Fund’s global gold holdings roughly proportional to its share in the total deposits of the Fund.

The Fund’s guarantees to depositors, however, cannot be any better than the Fund’s own assets, and might prove impossible to honor in full, in the case of defaults by its debtors. To guard against this, all Fund members might agree to channel through any defaulting country’s deposit account with the Fund all payments to be made to it in the future by any of them, until the default is fully covered. Such a guarantee would thus rest, not on the borrowing countries’ commitments, but on those of all Fund members, and on their interest in assuring the ultimate worth of their own claims on the institution.

Taken together, such guarantees would erect, indeed, stronger safeguards for the Fund’s depositors than any ever devised in past international lending operations.

Let us note, finally, that an agreed percentage of minimum deposits with the Fund—in relation to each country’s global reserves—might in time be substituted advantageously for the Fund’s general arrangements to borrow, and even for the cumbersome and wasteful procedure of capital subscriptions and periodic quota increases that now feed the lending potential of the institution. Each member’s contributions would, in this way, adjust automatically to the fluctuations of its balance of payments and reserve position and, therefore, of its lending capacity. The net claims accumulated on the Fund would, moreover, as is already the case now, remain perfectly liquid and usable to meet later deficits. The Fund would eschew, however, the absurdity of having to channel through the parliamentary or congressional procedures of scores of countries the vote of millions, or billions, of perfectly useless cruzeiros, bahts, and other kyats, on the occasion of each increase in its capital. It would also spare itself the ingenious acrobatics through which it now has to elude the deflationary impact of gold subscriptions, not only on the subscribing members, but also on the depleted gold reserves of the United States and the United Kingdom.

3. The distribution of Fund’s loans and investments

The more conservative members of this audience will be happy to hear that I do not propose any revolutionary revision of the present lending procedures of the fund. I am particularly wary myself of the suggestions of my old friend, and former chief at the fund, E. M. Bernstein, for a substantial increase in the automatic borrowing rights of fund members. Such automaticity might well be considered indeed, but only for moderate amounts, and relatively short-time maturities, designed to meet unforeseen situations and to provide the time necessary for a deliberate examination of a country’s problem and for the reaching of joint agreements on the amounts and purposes of the fund’s assistance. But it would be revolutionary and utopian,

indeed, to expect the lenders to accept large automatic commitments to finance blindly the future deficits of all and any country, without regard for the wisdom or folly of the policies which may be at the root of these deficits.

This is precisely the point at which the need for the growth of world reserves may be met in such a way as to promote and support indispensable readjustment policies, by surplus as well as by deficit countries, depending on the circumstances of such imbalances in world payments. Multilateral surveillance should—the Group of Ten has already told us—apply to the financing of individual countries' deficits as well as to the global pace of all forms of reserve creation.

If this financing were to remain constricted—as it has largely been so far—to medium-term loans, of 3 to 5 years' maturity, the gross lending that would prove necessary, year after year, to offset repayments and feed desired increases in world reserves would soon exceed all reasonable needs and uses for such medium-term assistance, while far more crying needs for longer term development financing would remain starved for adequate sources of funds.

I am well aware, of course, of the traditional objections to the use of liquid monetary deposits for long-term financing of this sort, either by commercial banks, or even by national central banks. These objections, however, would be totally irrelevant—as brilliantly shown by Professor Machlup—to the operations of a worldwide reserve center, such as recommended here. The inflationary dangers of long-term lending—as well as of short-term lending, for that matter—should be adequately guarded against through the overall ceilings, discussed above, on the Fund's portfolio increases, limiting those to agreed requirements for reserve growth. As for the danger of illiquidity, usually associated with long-term loans, it could not arise under the proposed system. The world pool of reserves being destined to grow overtime, with little or no probability that circumstances would ever require a sudden or massive contraction, the Fund should never have to face any drastic reduction of its deposit liabilities, forcing it to liquidate any substantial portion of its global assets. Balance-of-payments settlements among IMF reserve holders will reshuffle the Fund's deposit liabilities among its members, but should not reduce their total amount.⁴

Yet, there exist some valid reasons to limit the maturity of Fund loans and investments. The first is that such limitations will provide added flexibility for shifting the Fund's assistance from some countries to others, whose needs may be greater and exceed what the Fund can currently contribute from desirable increases in the total pool of world credit reserves.

A second reason why the Fund should not engage directly in long-term development lending is that such lending requires a very different type of knowledge and expertise than those that should be relevant to its primary tasks and purposes, that is:

- (a) a rate of creation of overall world reserves most appropriate to sustain noninflationary rates of economic growth;

⁴ This would not be strictly true if surpluses centered on countries with low ratios of IMF deposits to total reserves, and deficits on countries with high ratios. The problem would then have to be met through a reduction of the IMF gold reserves in the short run, and in the long run by the provisions, discussed on pp. 15 and 16 above, designed to prevent an undesirable contraction in the world reserve pool.

(b) a distribution of its corresponding lending power designed to stimulate the adoption and implementation of desirable readjustment policies by the beneficiaries;

(c) the reshuffling of such lending that may be needed to compensate large, but reversible, movements of private capital, particularly among major monetary and financial markets whose general policies are consonant with longer term equilibrium in their balances of payments.

The bulk of the Fund's assistance to long-term development financing should thus, in all probability, be channeled through—and cushioned by—intermediary institutions, specialized in such long-term lending. The Fund might, for instance, distribute its investment portfolio between marketable obligations of international institutions, such as the International Bank for Reconstruction and Development, and other short- or medium-term investments in the major financial centers—New York, London, Paris, Frankfurt, Amsterdam, and so forth—enabling these to engage more boldly and actively in long-term lending, in the knowledge that temporary pressures on the country's reserves would be offset by a reshuffling of the Fund's own investment portfolio. Such reshuffling would be particularly appropriate to meet the objectives now served by the Fund's general arrangements to borrow.

4. *Who shall decide?*

Last, but certainly not least, is the question of the appropriate machinery through which agreements are to be hammered out on all these issues calling for joint decisions among several scores of theoretically sovereign and independent—but actually interdependent—countries. Logically, the IMF should obviously be the main instrument to be used to that end. Yet, some of the main reserve holders of Western Europe strenuously object to relinquishing to the Executive Board of the Fund the management of the vast sums which they might be called upon to contribute in future years to the growth of world reserves. The EEC countries alone are already now holding close to two-thirds of the net claims that finance the lending operations of the IMF, but they wield only 15 percent of the voting power in all Fund decisions. The distribution of voting power in the Fund is indeed primarily determined by the relative size of each country's quota. Quotas, however, are tantamount to lending commitments for the creditor countries in the Fund, and to borrowing rights for the others. It is not difficult to understand the objections of the continentals to a system which rewards equally with voting power the obligation to lend and the right to borrow, especially at a time when the camp of the prospective borrowers includes not only several scores of less developed countries, but also the United States and the United Kingdom, which alone command more than twice as many votes in the Fund as the six EEC countries together.

I have long recommended two parallel solutions to this worldly problem. The first is to encourage a substantial decentralization of the Fund's operations and responsibilities, through positive encouragement to regional monetary cooperation and integration such as is being rapidly developed today in EEC and in Central America. This could indeed help to couch readjustment advice to individual countries in more realistic terms, and to avoid excessive criticism of the Fund

by countries which now bear little or none of the responsibilities of the Fund by countries which now bear little or none of the responsibilities for such advice and financing.

Article 108 of the Rome Treaty provides a most realistic model for such decentralization. Any disequilibria among the EEC countries themselves should be dealt with primarily by the EEC itself, and financed through a joint European Reserve Fund, as long advocated by Jean Monnet's Action Committee for the United States of Europe. This would reduce to a more manageable size the contributions which these countries should make to IMF itself, to cover disequilibria between the EEC area as a whole and the rest of the world.

A further, and not unreasonable, compromise might be to observe the voting procedures of the articles of agreement for normal quota drawings financed out of present capital subscriptions and future quota increases, but to establish a special open market committee to manage the investments financed from voluntary "deposits" additional to the quota subscriptions of the articles of agreement, and to give adequate recognition to the relative size of these deposits in determining the relative voting power of the depositors.

III. COMING DOWN TO EARTH

This bare outline has purposely skirted many complexities arising from vesting national interests—real or imaginary—in the preservation of some features of the present system, and from the need to provide a smooth transition from past habits and institutions to those that should gradually emerge tomorrow, in the light of practical experience and ad hoc precedents, as well as of purely logical and abstract theorizing.

In order not to abuse your patience this morning, I shall single out only one, but maybe the most crucial, of such problems: the need to deal with outstanding sterling, and particularly dollar, balances traditionally integrated into the international reserve system of yesteryears.

Let me observe, first of all, that the key currency role of sterling and the dollar in private trade and finance is quite independent of their reserve currency role for central bankers. The use of both currencies in the first of these two roles long preceded, and will long survive, their use in the second. In fact, the attractiveness of both sterling and the dollar as a key currency for private traders and investors is increasingly endangered today by the creeping exchange restrictions imposed by the United States and the United Kingdom on bank lending and other capital movements, in order to stem the gold outflows to which a reserve currency is necessarily exposed as a result of wanton conversions into gold metal of reserve balances accumulated abroad over many years past.

This constitutes indeed one of the major dangers today to the stability of the pound and the dollar, and of an international monetary system so closely tied to the fate of these two currencies. The third of the three tables distributed to you illustrates this point, alongside many others on which time will not permit me to comment today.

The reserve losses of the United States over the last 5 years stem largely from a spectacular reversal in the international movement of short-term capital. We were receiving up to 1960, as should be ex-

pected in the case of a major financial center, persistent inflows of short-term funds, averaging more than \$1 billion a year in the late 1950's, and which reached a peak of \$1.8 billion in 1959. This was succeeded by abnormal, but persistent, net outflows throughout the years 1960-64, averaging more than \$1.4 billion a year; i.e., a total shift of about \$2.5 billion in our net balance. This is more than twice our net reserve losses of last year.

While various factors—including interest rates—have undoubtedly played a large role in this dramatic reversal, closer analysis leaves little doubt about the importance of the speculative attitudes unleashed by the 1960 gold flareup in the London market. The outflow reached a peak (\$2.3 billion) in that year, and can be largely explained by an unprecedented inflow of short-term funds into Germany (\$1.1 billion) in the anticipation of a revaluation of the mark, and into private gold purchases (\$1 billion; i.e., nearly double the previous years' average) in anticipation of a revaluation of gold. It was at a low (only \$260 million) in 1963 when gold and exchange rate speculation was strongly discouraged by the unanimous rejection of gold revaluation by the Group of Ten and by unprecedentedly large gold sales by the U.S.S.R. in Western markets (\$550 million; i.e., more than twice the previous years' average).

There can be very little doubt, I think, that our residual deficit would soon disappear, and even probably be replaced by large surpluses, if agreement could be reached, along the lines which I shall presently describe, in order to delay for many years to come, or even forever, any expectation of a gold revaluation. This could hardly fail to induce a substantial disgorging from the enormous gold hoards accumulated by speculators over many years past, and particularly since 1960.

The case of Britain is not as clear cut as that of the United States. Current account surpluses in the British balance of payments have fluctuated widely over the past 7 years, and have often been insufficient to finance official grants and capital outflows. Yet, here too, net reserve movements show little or no correlation with the fluctuations in the current account balance, but often a striking parallelism—until 1964—with net inflows and outflows of private capital, and particularly short-term funds. Net reserve losses of \$1,600 million in 1961 and 1963 were associated with net outflows of \$1,500 million of short-term capital, while the \$770 million reserve gain of 1962 was practically equal to net short-term capital inflows of \$750 million, and the \$820 million reserve gain of 1960 was dwarfed by net short-term capital inflows of more than \$2 billion.

Speculative movements of short-term funds are clearly one of the dominant factors in the balance-of-payments problems of the two reserve centers of the gold-exchange standard. The threat which they constitute to the stability of the system would be substantially reduced if it were agreed that any contraction, as well as expansion, of the world reserve pool should be a matter for joint decisions by, at least, the major reserve holders.

As of last December, for instance, the \$24 billion of credit reserves held in foreign exchange were overwhelmingly made up of dollar (\$15 to \$16 billion) and sterling (about \$7 billion) claims. One of the major and most urgent objectives of any sensible reform should be to prevent any sudden or massive contraction of this large component

of world reserve through wanton conversions into gold metal, which their holders are now legally entitled to claim, but which would nevertheless prove both disastrous and impossible in practice if they made any extensive use of this legal right.

This unenforceable right to gold conversion should be abandoned in favor of feasible and adequate guarantees regarding the future exchange value of such claims and their continued usability in all balance-of-payments settlements. The cleanest way to achieve this objective would be to exchange all unrequited dollars and sterling balance of central banks for guaranteed deposits with the IMF, whose unqualified transferability for all balance-of-payments settlements would be based on the obligation—discussed above—of all reserve holders to retain a certain portion of their global reserves in the form of credit reserves rather than gold. (The same objective could, however, be served through the conversion of unrequited sterling and dollar balances into reserve certificates, with similar exchange value and transferability guarantees, although this would require additional provisions regarding the appropriate distribution of credit reserves between dollar and sterling certificates by each individual reserve holder.)

This leaves unresolved the question of eventual amortization of the United States and United Kingdom indebtedness transferred to the IMF or converted into reserve certificates. Since the need for any massive contraction of existing reserves can be ruled out in practice, not only as unnecessary but even as highly undesirable, any systematic provisions for contractual amortization of the resulting indebtedness of the United States and the United Kingdom should be regarded as equally unnecessary and even undesirable. Yet, amortization might be required from them in the two following cases:

(a) Whenever feasible and desirable to finance later surpluses of the debtor country. This provision would be particularly useful and appropriate in the event of large movements of private funds between the two reserve debtors themselves. The IMF, for instance, would be able to compensate such movements by an opposite reshuffling of the official dollar and sterling balances transferred to it initially, without exposing itself either to gold losses or to the need for invoking the general arrangements to borrow in order to obtain the necessary financing from either the United States or the United Kingdom.

(b) In moderate amounts, compatible with international stabilization objectives, whenever desirable to enlarge the ability of the IMF to lend to other deserving countries whose need for credit is greater than that of outstanding reserve debtors.

The lack of any explicit discussion of this problem of outstanding reserve currency balances by the Group of Ten constitutes undoubtedly the most glaring gap in their report of last August.

The future use of sterling and dollar balances as normal feeders and components of world reserves also presents a major hurdle to the negotiators of the Group of Ten. Even though it has already been agreed by them that "multilateral surveillance" should apply to all forms of reserve creation, the United States and the United Kingdom are reluctant to abandon the privileged position enjoyed by them in the past through the use of their national currencies as international reserves. Some Colonel Blimps even seem to regard it as a matter

of national prestige to have their country's national I O U's float precariously in the coffers of foreign central banks. Yet, the constraints which possible conversions of such I O U's into gold metal imposes upon the freedom of monetary and economic policy in the United States and the United Kingdom are likely to prove increasingly burdensome in the future, while the chances of any substantial piling up of further dollar and sterling balances in other countries' reserves are bound to become increasingly slimmer.

This does not mean, however, that the role of dollar and sterling balances in the world reserve system could be entirely dispensed with. They will retain, at the very least, an important function as working balances, to be used by central banks for daily interventions in the exchange market. This would, of course, remain true even if agreement were to be reached, as suggested above, for the concentration of all credit reserves in IMF deposits. Surplus countries would deposit in their account with the Fund unrequited foreign exchange balances bought from the market in excess of normal requirements for working balances. Deficit countries, on the other hand, would purchase from the Fund—against corresponding debits in their deposit account—the foreign exchange necessary to reconstitute their depleted working balances. Because of their wide use as key currencies in private trading and financial transactions, the dollar and the pound would retain the major role which they have traditionally played in this respect, although other currencies would not be barred from such use also.

Any attempt to preserve the use of national currency balances as international reserves—except for such moderate working balances—would complicate immensely the implementation of the "multilateral surveillance" principle agreed to last summer, without benefiting in any way either the United States or the United Kingdom if multilateral surveillance is to be equally and effectively enforced upon them as well as upon other countries. As long as credit reserves are held exclusively in the form of Fund deposits, as envisaged above, joint agreements need cover only the distribution of such deposits among reserve holders, and of correlative Fund loans and investments among prospective borrowers and financial outlets. If, however, direct dollar and sterling holdings are now retained alongside IMF deposits as normal components of each country's credit reserves, multilateral surveillance decisions will inevitably have to consider also the distribution of these three types of reserve media both between creditors and between debtors, and to assure the compatibility of this double distribution pattern. Each and every country will have to be induced to adjust the overall amount of its credit reserves between IMF deposits, dollars, and sterling in such a way that the combined result of their separate decisions will produce the agreed constellation of financing for the United States, the United Kingdom and other Fund members. Even worse, frequent, and often large, fluctuations in every country's global reserve holdings will force constant and complicated reshufflings, matching separately the dollars, sterling, and IMF deposits unloaded by the countries in deficit with the dollars, sterling and IMF deposits absorbed by the countries in surplus.

I cannot, therefore, but agree with those who consider that dollars and sterling should be replaced rather than merely supplemented by

the new type of international reserve asset whose creation is now being studied by the Ossola Committee. The seeming endorsement of this view by Prime Minister Wilson, at the conclusion of his conversations with General de Gaulle, 2 months ago, is particularly encouraging in this respect. The French themselves, on the other hand, have indicated that they would have no objection to the continued use of sterling and dollar reserves by countries traditionally regarded as forming part of the sterling and dollar areas.

A compromise might be reached therefore, under which the new system proposed above would be initially negotiated and fully implemented only by the major reserve holders of the Group of Ten, and would leave most other countries free to retain, as now, a substantial portion of their reserves in the form of dollar and sterling assets. The total amount of national currency reserves, including working balances, held at the end of last year by all of the less developed countries taken together totaled about \$6.9 billion; i.e., 10 percent of the world reserve pool. Since these countries are most likely to run large surpluses in the foreseeable future, the total amount of reserve which they might choose to accumulate in national currencies, or, for that matter, in gold, would be equally unlikely to endanger seriously the stability of the system as a whole.

Let me, in conclusion, add a few words about what is commonly regarded, even by its sympathizers, as the major obstacle to the acceptance of the Triffin plan. Hardheaded realists, as well as antiquated nationalists, fear that it would involve large and unprecedented surrenders of national sovereignty to a supranational world central bank, which could not operate effectively without the support of a world government.

These fears are totally groundless.

The IMF would, it is true, be a "lender of last resort," but this has been true from the very inception of the Fund 18 years ago. Neither the present nor the reformed IMF, however, would have any right to dictate individual countries' policies, nor any means to guarantee the stability and longrun equivalence of the national currencies of its members. These would remain free, as they are now, to reject the Fund's policy advice and to pursue what ever policies they wish, even if this involved in the end their inability to escape a devaluation of their currency.

Actual surrenders of sovereignty to the Fund would continue to depend on the amount of lending potential contributed to it by its members. The fact that some of these contributions would take the form of deposits rather than capital subscriptions would not reduce in any way the sovereignty of anybody, since these deposits would be at least as liquid as the present capital subscriptions, and any increases would have to agreed by the contributors just as is the case now for periodic increases in the Fund's capital.

The United States and the United Kingdom would, it is true, renounce the expectation of being able to palm off their short-term I O U's upon the world reserve pool. But they would also be protected against massive and unsustainable conversions of their past I O U's into gold metal. Who can doubt that this would restore to them a greater freedom of monetary management than they now enjoy? The threat of future gold conversions is certainly far greater

today than the likelihood of any substantial piling up of more dollar and sterling balances by the major reserve holding countries of Western Europe.

These large reserve holders, on the other hand, would give up their present legal right to wanton conversions of past dollar and sterling balances into gold metal. But they already know that this right has become largely theoretical and that its actual use could only precipitate devaluation, inconvertibility, or gold embargo decisions by the debtors. My proposals would safeguard them against such dangers, preserve the full liquidity of outstanding dollar and sterling balances for the purpose of international settlements, and protect each of them against the deflationary or inflationary pressures which the liquidation or accumulation of such balances by others can now unleash at any time upon the world monetary system. Note that none of them can escape such pressures by its own freedom of action. The fact that Mr. Holtrop can choose to accumulate his country's surpluses in gold rather than in dollar reserves does not protect the Netherlands against the inflationary pressures resulting, in his view, from the excessive financing of U.S. deficits by other central banks.

Finally, the underdeveloped countries could only, of course, welcome the expansion of the Fund's lending capacity, and particularly its indirect channeling into development financing via the Fund's investments in the IBRD, other international lending agencies and the major financial markets specialized in long-term lending.

If time had permitted, I would have concluded this talk with a brief discussion of the ways in which the various plans talked about today—the Stamp or Wilson plans, the CRU plan, the Maudling plan, the Posthuma or Blessing plans, the Bernstein plan, et cetera—fit into the synthesis which I have just outlined.

But time is running short for us here today as well as for the negotiators of the Group of Ten. I hope we shall all make good use of it in our ensuing debates, and that our success may inspire our official colleagues to speed up the pace of their own discussions and escape the fate of their unlucky predecessors of the Gold Delegation of the League of Nations, some 34 years ago, on September 21, 1931.

EXCERPTS FROM "THE EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM: HISTORICAL REAPPRAISAL AND FUTURE PERSPECTIVES" BY ROBERT TRIFFIN, PRINCETON STUDIES IN INTERNATIONAL FINANCE NO. 12, INTERNATIONAL FINANCE SECTION, PRINCETON UNIVERSITY, 1964.

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II. A HALF CENTURY OF INTERNATIONAL MONETARY ANARCHY: 1914-1964

A. *The Aftermath of World War I*

The financing of the first world war and of postwar reconstruction forced, as has always been the case in previous and later wars, sharp and inflationary increases in the monetary liabilities of national banking systems, while gold production expanded at a much slower rate than previously. The ratio of gold reserves to money supply—and foreign trade—thus fell drastically, well below the levels compatible with the maintenance of convertibility in most of the belligerent countries. Convertibility was suspended over a large part of the world.

Freely fluctuating exchange rates failed signally, in the following years, to restore a competitive price and cost pattern among the major trading nations, to induce the adoption of monetary policies compatible with even a moderate degree of stability in prices and exchange rates, and to bring about any sort of tenable equilibrium in the world's balance-of-payments pattern. They stimulated instead speculative movements of hot money which contributed to a considerable overvaluation of the pound sterling—at its old prewar parity—to a parallel undervaluation of the French and Belgian francs, to an utter collapse of the German mark, and to various degrees of overvaluation and undervaluation in the bilateral relationships among these and other currencies.

Currency convertibility was finally restored, in one country after another, in the second half of the 1920's, but under conditions which could not fail to usher in its early collapse, after a brief period of euphoria in some countries and of unendurable hardships in others.

First of all, the outflow of hot money from the European continent to Britain led to the adoption of fundamentally undervalued exchange rates in the first countries and of an overvalued rate in the latter, thus unleashing strong expansionary forces on the continent, but a deep slump in exports, economic activity, and employment in Britain.

Secondly, the return to convertibility had to be sustained by the reconstruction of adequate reserve levels by the central banks. This was achieved in the undervalued countries with the help of foreign

loans, of the revaluation of the outstanding gold and foreign-exchange assets of central banks at the new gold and foreign-exchange parities,²⁴ and of the large balance-of-payments surpluses stimulated by the undervaluation itself.

A substantial component of these surpluses, however, was constituted by the return of refugee capital from London, under the triple impact of currency stabilization and booming economic activity on the continent, and of the deep economic slump in Britain. The reconstruction of adequate reserve levels in Britain, on the other hand, had been achieved very largely on the basis of these previous inflows of continental hot money, and was now severely threatened both by its repatriation to the home countries and the attraction of Wall Street.

The British authorities were by no means unaware of the vulnerability of this position, and had long prepared two lines of defense to protect it. One was the agreement between Benjamin Strong, President of the Federal Reserve Bank of New York, and Montagu Norman, Governor of the Bank of England, to try and preserve higher interest rates in Britain than in the United States. The agreement became harder and harder to implement, however, in the face of the British slump and of the boom on Wall Street. The other line of defense was the attempt of Britain to propagandize the adoption—by other countries—of a so-called “gold-exchange” standard under which their central banks would hold a substantial portion of their international monetary reserves in the *national* currency of major trading and financial centers, i.e. very largely in sterling. This succeeded, for a while, in shoring up Britain’s slender gold reserves against the impact of speculative-capital withdrawals, following the stabilization of European currencies. Central-bank reserves of foreign exchange rose from about \$700 million in 1913 to more than \$3 billion in 1928, of which some \$2½ billion—i.e., three to four times the total gold reserves of England—may be estimated to have been held in sterling, legally convertible into gold on demand or on very short notice.

The Bank of France, however, showed itself increasingly reluctant to continue to retain as a permanent component of its reserves the whole amount of the sterling balances which it had to buy from the market in order to prevent a further appreciation of the French franc, after its sharp rise from 260 francs to 125 francs per pound in the latter part of 1926. Conversions of official French holdings of sterling into gold or dollars became a growing source of worry for the Bank of England, which had to plead also with other countries to refrain *voluntarily* from converting their gold-convertible sterling into gold.

²⁴ French gold and foreign-exchange reserves, for instance, rose from 5.5 billion old francs in 1927 to 64.7 billion new francs in 1928, 87 per cent of the total increase arising from the nominal revaluation profits resulting from the redefinition of the franc parity.

The financial sequels—particularly in Germany and Central Europe—of the 1929 world crisis finally swept away the fragile convertibility façade, so painfully restored in the late 1920's. Convertibility was once more suspended in Britain, on September 21, 1931, ushering in long years of international monetary chaos, compounded by the great depression of the 1930's, the second world war and its aftermath, and the worldwide spread of exchange-rate instability, exchange control, and bilateralism.

B. The Aftermath of World War II

The monetary aftermath of World War II presents a number of contrasts to, but also a striking similarity with, that of World War I.

Once again, wartime and postwar reconstruction financing brought about vast increases in money supply and a considerable decline in the ratio of international reserves to national monetary liabilities. Generalized recourse to exchange controls slowed down, or postponed, the exchange-rate readjustments which had characterized the 1920's, and bunched up many of them in September 1949. In spite of the 1949 devaluations, however, the ratio of gold reserves to money supply for the eleven major countries of the Paris Club, taken as a group, fell from about 39 per cent in 1937 to 19 per cent in 1949 (see Table 6 in Appendix I).

The pound sterling was, this time, engulfed also in the devaluations which swept the other European currencies. Its international status, as a reserve currency had never fully recovered from the 1931 collapse, and had been weakened further by the forced or semi-forced accumulation of inconvertible pounds by many countries, during and after the war. Refugee capital had flown, not to London, but to New York, contributing in the end to a long-term undervaluation of the European currencies in general in terms of the mighty postwar U.S. dollar.

Central banks once more accumulated a growing portion of their international reserves in the form of foreign exchange, alongside of gold metal, but this accumulation centered now on the dollar rather than the pound. The reserve liabilities of the United States to foreign monetary authorities rose from about \$0.8 billion in 1939 to \$8.7 billion in 1957 and \$12.9 billion in 1962 (see Table 15 in Appendix II).

The gradual undermining of the U.S. net reserve position from nearly \$23 billion in 1949 to about \$16 billion in 1957 took a more precipitous turn with the huge U.S. balance-of-payments deficits of the later years, when the effects of the relative undervaluation of the European currencies were compounded by the reflux of European refugee capital, following the restoration of currency confidence and convertibility in Europe. Net U.S. reserves declined by more than a half, from \$16 billion to \$7 billion, between the end of 1957 and the end of 1960.

The latent dollar crisis burst into the open in October 1960, with the sudden flare-up of gold prices on the London market.²⁵ The reversal of short-term private-capital movements has continued, ever since, to exercise a heavy drag on our overall balance of payments. Normal inflows averaging \$500 million a year in the early 1950's and about \$1 billion a year in the late 1950's were replaced by persistent outflows of more than \$2 billion in 1960, and about \$1.6 billion in each of the following two years (see Table 14 in Appendix II).²⁶

The gold drain from the United States was kept at tolerable levels by the accumulation of dollar balances by foreign central banks, but as these continued to pile up the U.S. authorities had, like Britain some thirty years earlier, to try and elicit, through bilateral and multilateral discussions and negotiations, voluntary restraints on the conversion into gold of the gold-convertible dollar balances accumulated by foreign central banks under the ill-fated gold-exchange standard. Continuous efforts had to be devoted also to eliciting international cooperation in discount and interest-rate policies—as had also been hammered out in a reverse direction between Benjamin Strong and Montagu Norman in the late 1920's—so as to moderate short-term capital outflows from New York to the European markets. Once more, such policies proved harder and harder to impose, or preserve, in the face of national economic conditions calling for an exactly opposite pattern of interest rates, in Europe as well as in the United States.

In brief, the contrast between financial and economic developments in the United States and in Europe after World War II closely resembles the previous contrast between developments in the United Kingdom and in continental Europe after World War I:

1. In the early postwar years, large movements of private capital and central-bank funds from Europe to the United States;
2. The consequent undervaluation of European currencies in relation to the dollar, when a new and durable pattern of exchange rates emerged, in September 1949, under the influence of such capital movements;
3. The resulting stimulation of exports and economic activity in Europe, and downward pressures on growth rates and employment in the United States;
4. The repatriation of European refugee capital, under the double

²⁵ The influence of the cessation of U.S.S.R. sales, and of other accidental factors, was sharply aggravated by the sudden withdrawal of the Bank of England from the market, following dark hints by our own Treasury officials that the support operations of the Bank might not fall within the scope of "legitimate monetary purposes" conditioning central banks' access to the U.S. Treasury gold.

²⁶ See also R. Triffin, "The Latent Crisis of the Reserve Currencies," *The Banker*, London, August 1963.

impact of (2) and (3), after the restoration of confidence in European currencies;

5. The acceleration of U.S. capital outflows and reserve losses, prompted by speculative expectations of possible changes in gold prices and exchange rates, as well as by the differential evolution of earning prospects and interest rates in Europe and in the United States under the impact of (2) above;

6. The growing conflict between domestic and external criteria governing the choice of credit and interest-rate policies, on both sides of the Atlantic; and the predictable frustration of European attempts to persuade the U.S. authorities to raise interest rates in the face of heavy unemployment, as well as of American attempts to persuade European authorities to lower interest rates in the face of heavy inflationary pressures at home;

7. The U.S. efforts to elicit further purchases and retention of dollar balances by foreign central banks, and to discourage conversions of such balances into gold or foreign currencies;

8. Protracted discussions and negotiations on the need to remedy the gold—or liquidity—shortage and the instability inherent in the haphazard accumulation and liquidation of foreign exchange reserves under the gold-exchange standard.

There remain, fortunately, major differences between the British monetary problem in the aftermath of World War I and the United States problem today.

First of all, the world economy is in far better shape today than it was in 1931, and the overall economic and financial position of the United States far stronger than that of 1931 Britain.

Secondly, the world's financial and political leaders are now keenly aware of the disastrous consequences which any repetition of the 1931 policies, or lack of policies, could entail for the international monetary and economic order of the West. They have also developed since the second world war deeply ingrained habits of cooperation in vital matters and laid the foundations, at least, of the worldwide and regional monetary institutions necessary to organize, on a durable basis, the functioning of an international monetary system adapted to the realities of the financial, economic, and political interdependence of their theoretically sovereign countries.

C. Stopgaps and Expedients

This spirit of cooperation found its first expression in the negotiation, under the able leadership of Per Jacobsson on the one hand, and of Under Secretary of the Treasury Roosa on the other, of a bewildering array of multilateral and bilateral agreements, designed to shore up

the U.S. dollar and the international gold-exchange standard—now so dependent on the continued stability of the dollar—against the crises which threaten them both. While these agreements should, in the end, pave the way for more fundamental and systematic reforms of our outworn international monetary system, their negotiation was accompanied at first by indignant denials of any need for such reforms.

The accent was put throughout on the need to protect the reserve currencies, and the gold-exchange standard itself, against sudden shifts by reserve holders or private speculators from one currency into another or into gold. Two different methods of approach were successively followed to fulfil that aim.

The first was to increase the International Monetary Fund's lending resources, thus enhancing its ability to intervene in cases of crisis. The normal capital resources of the Fund were increased by more than 50 per cent in 1959, and a further \$6 billion of resources were negotiated among the so-called Group of Ten,²⁷ in 1961-62, to be made available to the Fund "when supplementary resources are needed to forestall or cope with an impairment of the international monetary system . . . in the new conditions of widespread convertibility, including greater freedom for short-term capital movements."

The second approach was through less formal short-term commitments of mutual support among the central banks of roughly the same group of countries, plus Austria, Switzerland, and the Bank for International Settlements. We can range under this heading the support extended to sterling on two occasions—in March 1961 and March 1962—by a group of other central banks, the so-called gold pool in operation since December 1961, and, most of all, the vast array of bilateral swap and swap stand-by agreements, and purchases of non-marketable dollar and foreign-currency securities, negotiated with major financial centers in the last two years by Mr. Roosa.²⁸ Mention should also be made of the Monetary Committee of the EEC countries, and of Working Party No. 3 of OECD, which review periodically developments and policies bearing on international payments and monetary stability of the member countries, individually and as a group.

²⁷ The United States, the United Kingdom, Canada, Japan, Germany, France, Italy, the Netherlands, Belgium, and Sweden. Since the agreement is primarily designed to cushion dangerous capital movements *between* the signatories themselves, the *maximum* resources callable could not, however, exceed half of the total, and are most unlikely to reach even that figure. For further analysis and criticism of this agreement, see my "Lendemains de Vienne: Mesures conservatoires et germes d'avenir," in *Trois Études sur le Problème des Liquidités Internationales*, Banque Nationale de Belgique, April 1962, pp. 15 and 16.

²⁸ Operations under these agreements are summarized periodically in reports prepared by Charles A. Coombs and published in the *Federal Reserve Bulletin* (see issues of September 1962, March 1963, and September 1963).

Considerable success was achieved thereby in offsetting and discouraging the speculative capital movements which have threatened, ever since October 1960, the two key currencies—sterling and, particularly, the dollar—on which the international gold-exchange standard is anchored. On the other hand, most of the commitments described above remain of a short-term character, subject to frequent renegotiation, and aim only at warding off future crises in the international monetary system, rather than at eliminating the basic vulnerability of the system which is at the root of such crises.²⁹

D. *The Process of International Reserve Creation over the Last Half-Century*

This vulnerability emerges clearly from even the most cursory examination of the actual process of international reserve creation over the last fifty years (see Tables 8-12 in Appendix II). For the world as a whole,³⁰ international monetary reserves had increased by 1962 to nearly fourteen times their 1913 level, i.e. at an average rate—on a compound basis—of about 5.5 per cent a year, but with a considerable range of variations, from actual declines in the years 1929-32 to nearly 7 per cent a year in 1914-28.

The role of gold in gross world reserves has fallen from 85 per cent in 1913 and 95 per cent in 1933-34 to about 60 per cent in 1962. Even more striking is the steadily decreasing role of Western gold production as a source of current reserve increases. From 78 per cent of such increases in 1934-37, it fell to 51 per cent in 1938-49, 30 per cent in 1950-57 and less than 19 per cent in 1958-62. In these last five years, the overall reserve increases derived from Western gold³¹ production alone represented an average growth rate of roughly one half of one per cent a year in total world reserves, only slightly larger on the average—and far smaller, in fact, in 1960 and 1962—than the amounts derived from U.S.S.R. gold sales in Western markets.

Overall reserve increases have been fed overwhelmingly, and increasingly, over the last fifty years, from other, and even more erratic sources:

1. The withdrawal of gold coin from active circulation and from commercial banks' cash reserves. This source of supply accounted for

²⁹ For a more detailed review of the measures briefly summarized in the above text, see the excellent study of Robert Z. Aliber on *The Management of the Dollar in International Finance* (Princeton Studies in International Finance, No. 13, to be published later this month).

³⁰ Excluding the Eastern bloc countries. The same qualification will, regrettably, apply throughout to all reserve statistics, owing to the unavailability of reliable information. See, however, the note presented in Appendix II on U.S.S.R. gold production and reserve estimates.

about 31 per cent of total reserve increases over the years 1914-28, but finally dried up in 1933.

2. The devaluation of the dollar accounted for more than the total reserve increases of the years 1929-33, which would, otherwise, have been negative owing to the wholesale liquidation of foreign-currency reserves by central banks.³¹

3. The net impact of IMF transactions contributed 7 per cent of world reserve increases over the years 1950-57, and 9 per cent in the following five years.

4. Russian gold sales to the West have, as already mentioned, fed a modest, but increasing proportion—up to 14 per cent in 1958-62—of the Western world's reserve increases, and about two-thirds of the small gold reserve increases of the years 1960 and 1962.

5. Finally, the lion's share of the overall reserve increases has been derived increasingly, but most erratically, from central-bank accumulation of national currencies as international reserves. From 30 per cent in 1914-28, it dropped to *minus* 28 per cent in 1929-33, recovered to a modest 17 per cent in 1934-37, rose sharply to 49 per cent in 1938-49, and to about 58 per cent in 1950-62. Sterling remained the largest component, by far, of such so-called key-currency reserves until the end of the second world war, but has ceased since then to contribute any significant amount to the world reserve pool. Its place had been taken by the dollar balances which, alone, contributed more than ~~half~~ of the world's reserve increases in the period 1950-62.

Adding to this the U.S. gold losses and reduction of net claims on the IMF, we see that other countries derived from net U.S. reserve losses nearly 60 per cent of their total reserve increases in 1950-57, and 80 per cent in 1958-62, i.e., in these last five years nearly eight times as much as the amount of reserves derived from gold production in the West (see Table 13 in Appendix II).

Nobody can any longer seriously defend such a system—or rather lack of system—as a safe and rational way to regulate the increase of international reserves which must serve as the ultimate basis, particularly under convertibility conditions, for the increases in national money supplies necessary to support growing levels of production and trade in an expanding world economy. Legitimate, non-inflationary reserve requirements of economic growth can hardly be defined—and met—by the algebraic addition of the monetary gold released by new production in a country threatened with civil war and by Premier Khrushchev's sales in Western markets, *minus* the erratic amounts absorbed by private gold speculators and industrial and artistic uses,

³¹ This calculation is based on the shift of the gold price from \$20.67 to \$35.00 an ounce, although this new parity was not legally determined until January 1934.

plus the financing of variable U.S. (and subsidiarily U.K.) deficits through autonomous or induced accumulation of dollar (and sterling) IOU's by central banks, minus the ever possible conversion into gold metal of such IOU's accumulated over many years past.

Our present international monetary system is not necessarily deflationary. It may, on the contrary, lead to excessive reserve creation at times, and unduly weaken normal balance-of-payments disciplines for the reserve-currency countries. In the longer run, however, even "normal" and desirable contributions of the reserve currencies to the maintenance of an adequate growth rate of the world reserve pool inevitably entail a persistent decrease in the net monetary reserves of the reserve-currency debtors, and a gradual undermining of the acceptability of such currencies as safe reserve assets for other central banks. After that point is reached, the only alternative paths still open to national monetary authorities are to accept and enforce world deflation or restrictions, to trigger the devaluation of the reserve currencies—followed by a spiral of other devaluations to offset the ensuing distortion of competitive export and production costs—or to continue to hold and accumulate, more and more reluctantly, the reserve currencies in order to ward off such a devaluation.

Even if the latter path is adopted—as it has been over the last few years—the growing mistrust of private speculators in the ultimate stability of the system is likely to aggravate the difficulties of the reserve currencies in question, and to impel central banks to step up their stabilization interventions and absorb even larger amounts of reserve currencies than would otherwise be necessary.

Such, at least, was my "diagnosis" in *Gold and the Dollar Crisis*, written in 1958 and 1959, and which subsequent events would hardly lead me to repudiate today. As for the "prescription" proposed at that time, I would still regard it as basically valid, with minor adaptations to take account of recent developments and particularly of the ever changing course of negotiating obstacles and opportunities.

I shall, in the next section of the present study, present a bold—and somewhat academic—outline of the long-run aims that should, in my opinion, guide and inspire future attempts at monetary reform. This outline will systematically ignore the realities of the negotiating process itself, and leave for the concluding section of this study the examination of the compromises—acceptable or undesirable—which are likely to emerge from the current exploration of international monetary reforms at long last launched during the last annual meeting of the IMF, in October 1963.

III. THE LONG-RUN EVOLUTION OF OUR INTERNATIONAL MONETARY SYSTEM

A. *A Single Reserve Center*

The long-term consolidation of the international reserve system, and the adaptation of international reserve creation to the full, non-inflationary growth potential of the world economy, would obviously be enormously facilitated by the adoption of a single clearing and reserve Center for national central banks. Each central bank would hold all of its monetary reserves—except for moderate, day-to-day working balances—in the form of international deposits with such a center.

Central banks would acquire, at the start, their initial reserve deposit with the Center by transferring to it their outstanding holdings of gold and other convertible reserve assets (see D below).

B. *Cash Settlements*

The Center would then operate as a clearing agency for all subsequent international settlements not cleared by the private exchange market itself. Three types of operations would come under this heading:

1. Direct settlements among central banks would be effected by mere bookkeeping transfers, debiting the account of the payor, and crediting the account of the payee.

2. Stabilization interventions by central banks on the exchange markets involve either the purchase, or the sale, of foreign exchange by the bank concerned. The foreign currencies needed to reconstitute working balances depleted by such sales would be bought from the Center, through corresponding debits in the buying bank's reserve account. Conversely, foreign currencies—in excess of working balances—accumulated by a central bank in opposite stabilization interventions would be transferred to the Center and credited to the depositing bank's reserve account.

The reserve account of the central bank whose currency had been sold to the Center would be debited by the amount transferred. In the opposite case when a currency is bought from the Center, two alternative techniques could be considered. The simplest one would be for all central banks to authorize the Center to sell their currency directly against corresponding credits to their reserve account. The other would be for the Center to accumulate and maintain adequate

working balances in the major currencies used in fact in such stabilization operations.

3. A third type of cash transaction would relate to the Center's purchases and sales of gold, and depend very much on the future policies jointly adopted among the world's monetary authorities regarding the suspension or continuation of the support extended by them up to now to the stabilization of gold-metal prices.

Under the radical reforms envisaged above, gold could well be dispensed with as a medium of reserve accumulation, by the Center as well as by the national central banks. The essential requirement of a national currency is to be generally acceptable in payment within the country's borders. Such general acceptability can be elicited by other means than convertibility in gold metal, in one case as well as in the other, and we shall examine below²² how this could be done.

The continued guarantee of stable gold prices by the Center, or the world central banks, would then be tantamount to a decision to continue the traditional support given to gold-metal prices by the purchases of the monetary authorities. The main arguments in favor of such a policy would be:

1. to take advantage of the continued popular illusion that gold reserves alone can constitute an effective barrier against inflation and a proper backing for the liabilities of central banks—or of the proposed Center itself;
2. to avoid the bookkeeping losses that a demonetization of gold would almost certainly entail;
3. to avert a sudden disruption of the economies of the major gold-producing countries.

None of these arguments is very powerful, and the latter two problems could be solved, in a different manner, on their own merits. On the other hand, the continuation of gold support prices might well require very large purchases of gold, and unleash inflationary increases in world reserve assets and monetary liabilities, if the contemplated reform were to trigger large gold dishoarding by speculators. This would not be inconceivable, once people fully realized that such a reform had equipped central banks with ample means to dispense with gold altogether, and—at the very least—to rule out any probability of an increase in world gold prices in the foreseeable future.

If the decision were nevertheless adopted to support the world gold price at its present level, official interventions in the private gold market could be conducted either by the Center itself, or by the central banks. In the latter case, central banks would sell to the Center—

²² See p. 36.

against corresponding credits to their reserve account—any gold purchased in the course of such stabilization operations; and they would buy from the Center—against corresponding debits to their account—the gold they might need to sell.

Until the U.S.S.R. and the countries associated with it decided to join the Center, any of the techniques described above would strengthen the Western world against any possible abuse of the large gold stock—and gold production—of these countries for disruptive interventions, of an economic-warfare character, in the Western gold markets.

C. Credit Operations

The major central banks, at least, will probably wish to continue to increase their reserve levels—in future years as well as in the past—in order to facilitate the maintenance of international convertibility, at stable rates of exchange, of the rising amounts of their national currency issues needed to support expanding levels of production. The mechanism of reserve creation should adjust to this fact and promote a continuous adaptation of the world's reserve pool to the demand for reserves associated with feasible rates of non-inflationary growth in world trade and production.

Under the reform suggested here, all—if gold price support is abandoned—or a large portion, at least, of the necessary reserve increases would have to be derived from the progressive expansion of the Center's loan-and-investment portfolio. The pace of overall increases should be determined jointly, in the light of—and in such a way as to combat or moderate—discernible inflationary or deflationary pressures of a worldwide character.

Prospective surplus countries, however, will probably want to incorporate in Treaty form some guarantees against inflationary abuses of the Center's lending potential, since indeed this potential would otherwise be unlimited.³³ Such a Treaty might specify, for instance, a presumptive ceiling of 3 to 5 per cent in any twelve-month period, on the net expansion of the Center's global assets and liabilities. Such a ceiling would not necessarily be reached in any period of time—particularly at times of inflationary pressures—but it could not, in any

³³ Excessive lending to deficit-prone countries would merely increase *pari passu* the assets and liabilities of the Center. Subsequent drawings on their deposits by the borrowers could only reshuffle the Center's liabilities among its depositors, without producing any decline in overall liabilities. A worldwide Center would therefore be exempt from the discipline exercised upon a national central bank by national balance-of-payments deficits, in the same way as a national central bank can elude the discipline exercised upon commercial banks by losses of deposits from the more expansionary to the less expansionary banks of the system.

case, be exceeded, except by qualified voting majorities of two-thirds, three-fourths, etc., of the total voting power.

Within these broad limitations, individual loan and investment operations would be designed to support mutually acceptable policies of member countries against temporary balance-of-payments pressures, thus providing a powerful stimulus for the long-run harmonization of members' policies, and the avoidance of unnecessary recourse to exchange restrictions, devaluation, or deflation by the deficit countries.

Desirable balance-of-payments disciplines upon countries following persistently inflationary policies would therefore be maintained, and indeed reinforced. No country could escape them through the automatic, but erratic and precarious, access to international borrowing enjoyed in the past by the reserve-currency countries—a type of borrowing the haphazard use and liquidation of which could unleash at any time highly disruptive forces upon these countries themselves, upon the rest of the world, and upon the stability of the international gold-exchange standard.

The nature of the Center's lending operations would have to be adapted to the character of the resources used by it. Since its overall portfolio would be called upon to expand continually—although at a variable rate—over the years to come, but rarely—if ever—to be substantially contracted, some of its loans and investments might be granted in theory for extended maturities. They might even take a form similar to that of the famed British "consols," without any repayment date whatsoever, but on which interest would be paid indefinitely by the borrowers. This would make it easier to channel the world's thirst for reserves into long-term development financing of the countries most in need of such assistance.

Yet, direct long-term loans to, or investments in, the underdeveloped countries by the Center may well be regarded as unadvisable as well as unnecessary in practice. They would, first of all, have to overcome powerful taboos in the financial community whose "orthodox" canons, inspired by commercial-banking criteria, would damn any long-term assets as inappropriate backing for the short-term liabilities of a monetary institution. Secondly, even though its total portfolio would not be subject to the threat of sudden and massive contraction, the Center should remain able to reshuffle its loans and investments among members, in order to counteract undesirable capital movements and other short-term disturbances in the international balance-of-payments pattern. Thirdly, long-term investments require a very different type of knowledge and expertise than those that should be relevant to stabilization interventions in the exchange market.

The bulk of the Center's assistance to long-term development

financing should thus, in all probability, be channelled through—and cushioned by—intermediary institutions, specialized in such long-term lending. The Center might, for instance, distribute its investment portfolio between marketable obligations of international institutions, such as the International Bank for Reconstruction and Development, and other short-term or medium-term investments in the major financial centers—New York, London, Paris, Frankfurt, Amsterdam, etc.—enabling these to engage more boldly and actively in long-term lending, in the knowledge that temporary pressures on the country's reserves would be offset by a reshuffling of the Center's own investment portfolio.

Taken in conjunction with one another, the credit criteria suggested above would essentially tend to recreate some of the basic features of the adjustment mechanism of the nineteenth-century gold standard.³⁴ Vast amounts of private long-term lending then cushioned, for long periods of time, the current-account deficits of developing countries and made more bearable and acceptable the discipline exercised upon monetary policy by residual balance-of-payments pressures. Fifty years of monetary and economic instability and the constant threat of governmental interference in private contracts have paralyzed, or perverted, much of these private capital flows in modern times. They can be revived, in part, and redirected by official policies designed to stabilize the international framework in which they take place. They have, in addition, been supplemented by official lending which can itself be further encouraged, and better distributed as between the U.S. and other countries, by the international underwriting of monetary stabilization policies.

Similarly, concerted international action is necessary today to harmonize relative rates of monetary and banking expansion in such a way as to preserve long-run balance in the international pattern of payments, without unnecessary recourse to trade or exchange restrictions or exchange-rate readjustments. Market pressures, arising from deposit losses and cash settlements by the more expansionist to the less expansionist banks, usually sufficed, in the nineteenth century, to ensure such harmonization among *individual* banks—and therefore, among national banking systems—*irrespective of the existence of national political borders*. This ceased to be true as

1. commercial banks' cash assets progressively shifted from internationally acceptable commodity moneys—gold and/or silver—to nationally issued credit money; *and*

2. central banks' credit policies and monetary issues became more and more responsive to a variety of national objectives—such as price

³⁴ See above, Section I, pp. 9-10.

stabilization and satisfactory employment levels and growth rates—competing with, and often overriding, their initial concern with the maintenance of international reserve levels fully adequate to preserve full convertibility of their own liabilities into gold or foreign exchange, at stable rates.

International consultation among responsible national monetary authorities has thus become the only effective channel for the development of compatible and mutually supporting policies, and the minimization of unnecessary recourse to internationally disruptive, contagious, and mutually defeating policy measures. Unilateral action by the deficit countries alone to eliminate rapidly any emerging balance-of-payments disequilibria—whether lasting or temporary—often contributes to the unnecessary adoption and spread of deflation, devaluation and/or trade and exchange restrictions among member countries. Concerted action by surplus and deficit countries alike can certainly offer far more attractive, even though often slower-acting, means to correct such disequilibria over time, with a minimum of disruption of the national economies concerned. Conditional access to the Center's lending resources would (1) provide an added stimulus to such policy harmonization, and deterrent to unilateral action, (2) supplement the deficit country's ability to finance residual, temporary deficits through the depletion of its independent monetary reserves, and (3) discourage speculative capital movements which might otherwise create further, and possibly unbearable, drains on such reserves.³⁵

D. Consolidation of Outstanding Currency-Reserve Balances

The transition from the old system to the new would, of course, involve a once-and-for-all type of credit operations determined by the Treaty itself, i.e. the transfer to the Center of the large currency-reserve balances now held by member countries.

The Center would, as a result, initiate its operations with large credit claims on the United States and the United Kingdom, inherited from many years of functioning of the gold-exchange standard. There would be no reason to liquidate systematically such investments, long incorporated into the international reserve system itself. Provisions for their amortization—through equivalent debits to the debtor's reserve account—should be limited in the following manner:

1. voluntary amortization, at the request of the debtor;
2. compensatory amortization up to the amounts of current reserve

³⁵ Complementary—and partly alternative—measures aiming at a better adaptation of the world reserve pool itself to non-inflationary growth requirements of the world economy are amply discussed in other sections of this paper.

increases bringing their overall level above some agreed—"normal" (?)—ratio to the country's imports; and, possibly, if regarded as necessary,

3. an optional right for the Center to request additional amortization by no more than x per cent—5 per cent, for example—of the country's outstanding debt balance; such option, however, to be exercised only

- (a) when deemed necessary to meet other countries' legitimate requests for assistance without expanding the global loan and investment portfolio of the Center; and
- (b) when compatible with the preservation of an adequate reserve level and the pursuit of internationally acceptable policies by the debtor.

E. *International Guarantees*

All the claims and debts of the Center should obviously carry adequate guarantees against unilateral inconvertibility or exchange-devaluation decisions, or default by the debtors. Some common unit of account, adapted from the EPU unit of account, could be used for that purpose in all Center transactions, and embody in effect an exchange guarantee in terms of whichever currency remains most stable in the future. Alternatively, this exchange guarantee could be expressed in terms of a weighted average of the major currencies used in world trade and payments.

Guarantees against default could be provided in two ways:

1. through a commitment of all members to channel, as far as possible, through the defaulting country's account with the Center, all payments due to it until the default is made up;

2. through a geographical distribution of the Center's gold assets, approximating, on a *pro rata* basis, the pattern of the Center's deposit liabilities to its members.

Such guarantees would indeed erect stronger safeguards against defaults than any ever devised in past international lending operations.

F. *Surrenders of National Sovereignty?*

Proposals such as these are lightly shrugged off in many circles as involving revolutionary surrenders of national sovereignty to a worldwide "super-bank," incapable in fact of discharging its responsibilities without the full backing of a supranational world government. "The money created by a super-bank would be the most high powered ever generated by a man-made institution, yet it would have no supporting super-government to make good on its debts or claims. . . . Simply to establish the super-bank would require all countries of the

world to give up their present reserves and accept instead the fiat issue of a super-authority existing without a super-state."³⁶ These emotional slogans bear little or no relation to the concrete content of the long-term proposals developed above. They are even less relevant to the more modest suggestions for short or medium-term negotiations that will be outlined in the following section of this study, and which would merely streamline and rationalize the technical provisions endowing the International Monetary Fund with whatever level of lending capacity is deemed appropriate by its members, and is now derived from equivalent, but far more rigid, arbitrary and cumbersome capital subscriptions and other national commitments (such as those embodied in the so-called "General Arrangements to Borrow").³⁷

Reserve holders would retain, under the plan, far more control over the size and use of future accretions to world credit reserves than they have had—or now have—over the size and use of the IOU's dropped by the reserve-currency centers into the world's reserve pool. They would, it is true, renounce their present right to sudden and massive cashing of their credit reserves into gold metal, but they well know that such a right has already become largely theoretical and could not be exercised in fact on a large scale without bringing to an end the effective convertibility of the currencies involved, and without causing the collapse of the international gold-exchange standard itself.

Prospective borrowers, on the other hand, would in no way be forced to accept the advice—and the investments—offered them by the Center. They could refuse both, if they wish, particularly as the Center could not invest in their market without obtaining from the national authorities in charge the exchange guarantees described under E' above.

Present reserve borrowers, moreover, would regain—through the transfer to the Center of their outstanding indebtedness to central banks—a degree of control over future monetary policies strongly handicapped today by the volatile character of this indebtedness.

Neither would the joint consultations and decisions relating to the Center's investments be revolutionary in character nor involve necessarily the setting up of supranational institutions or voting rules. The

³⁶ Robert V. Roosa, "Assuring the Free World's Liquidity," *Business Review Supplement*, Federal Reserve Bank of Philadelphia, September 1962, p. 8. More concrete objections are developed in the following paragraphs of the text, which quote the conflicts and disturbances which might arise from sudden shifts by individual countries from international deposits to national currency holdings or to gold metal. This might better be formulated, however, as a valid stricture on the present gold-exchange standard than as a criticism of proposals specifically designed to protect the international monetary system against such unnecessary sources of disturbance.

³⁷ See below, pp. 47-48.

IMF and the EPU, for instance, have long functioned essentially along the lines suggested here without raising any objection to their supranational character.

Finally, the Center could hardly be described as a world central bank, since its reserve liabilities would circulate only among the national central banks themselves, and these would retain full control over, and responsibility for, their currency issues, each within its own national territory. One consequence of this is that exchange readjustments could in no way be ruled out, and would indeed prove imperative at times for countries which failed to harmonize their monetary policies with those prevalent in the world community.

This raises a broad question which cannot be adequately explored within the confines of the present paper, i.e., the proper scope of institutional commitments to exchange-rate stability.

G. *Stable versus Fluctuating Rates*

This question is usually discussed in abstract terms as if the same solution were always advisable for all countries and at all times. I would prefer to answer it in terms very similar to those given to it in a recent paper of Ronald I. McKinnon.³⁸

I have myself long expressed a preference for stable exchange rates, subject to readjustments only in the case of obvious failure to preserve adequate cost competitiveness for long-run equilibrium in the country's balance of payments at optimum levels of employment, economic growth, and trade and exchange liberalization. This preference was based on three main arguments:³⁹

1. Stable exchange rates tend to spread and even out among the trading countries the inflationary and deflationary gaps arising from differential rates of national monetary and financial expansion. Balance-of-payments disequilibria and changes in monetary reserves provide, under this system, an alternative outlet to the development of domestic pressures—upward in the more expansionist countries, and downward in the less expansionist ones—upon prices and employment, and do indeed bear a far closer relationship to differential rates of monetary expansion than to differential changes in national price and cost levels.⁴⁰ The latter tend in fact to be kept roughly in line with one

³⁸ "Optimum World Monetary Arrangements and the Dual Currency System," *Banca Nazionale del Lavoro Quarterly Review*, Dec. 1963, pp. 368-396. See also a brief communication on "Optimum Currency Areas" in *The American Economic Review*, September 1963, pp. 717-725.

³⁹ See *Gold and the Dollar Crisis* (Yale University Press, 1960), pp. 82-86.

⁴⁰ See Robert Triffin and Herbert G. Grubel, "The Adjustment Mechanism to Differential Rates of Monetary Expansion Among the Countries of the European Economic Community," *Review of Economics and Statistics*, November 1962, pp. 486-491.

another through the impact of competition in internationally traded goods—and particularly by export competition in third markets—as long as domestic policies can be readjusted in time to avoid devaluation or trade and exchange restrictions, isolating national price levels from one another.

Freely floating rates—à la Friedman—would “bottle up” within each country’s borders the inflationary or deflationary pressures arising from every expansionist or contractionist error in domestic policies. Exchange-rate fluctuations would absorb the full brunt of the disequilibria formerly cushioned by reserve gains or losses, and help preserve competitiveness in each country’s current-account transactions; but they would also lift the barrier previously erected by stable exchange rates against divergent movements in national price and cost levels.

The upward flexibility of wage rates would, moreover, tend to sanction with permanent and irreversible wage increases any inflationary mistakes or mishaps in monetary and credit policies, and any consequent increases in foreign exchange rates, import costs, and consumers’ prices; while deflationary errors would be unlikely to result in parallel, and offsetting, downward wage adjustments in a modern economy. Freely floating rates could hardly fail, therefore, to introduce a permanent bias toward currency depreciation—at least in terms of goods, if all countries adopted the system—and to elicit from Friedman’s highly farsighted speculators one-way flights from the national currency into equities, real assets, gold, and/or foreign exchange, rather than alternating, and “stabilizing” capital inflows and outflows. Such de-stabilizing capital movements might, it is true, still be dubbed “equilibrating,” but merely in the sense of accelerating the adjustment of exchange rates to price and cost disparities fostered by the system itself, and which might have been avoided under a system of stable exchange rates.

2. Secondly, “managed” floating rates—à la Meade—are too often advocated as though each country could determine by itself a desired rate in respect to all other countries. Exchange rates, however, express a relation between *several* currencies. Will the sterling-dollar rate, for instance, be abandoned by the United States to British management, or by the United Kingdom to U.S. management? And what will happen if the countries involved take a different view of the “desirable” rate between their currencies? (Meade himself is, of course, perfectly logical in his proposal, and recognizes that it involves the surrender of such management, by all countries, to an *International Equalization Account*).

3. Finally, I doubt whether floating rates can really provide, in the long run, a viable bridge between persistently divergent national monetary policies. They are far more likely to be a form of escapism, for which other and better methods could be substituted in the case of merely temporary lapses from responsible monetary management, and which would merely end in currency collapse in the case of protracted inflationary developments.

The spectacular growth and success of European monetary cooperation and policy harmonization since World War II seems to me to demonstrate the feasibility of an alternative path, far more deserving of support than the advocacy of exchange-rate-flexibility palliatives to monetary nationalism.

Yet, I would agree that these arguments are particularly applicable to the case of exchange relations between relatively small, highly open and competitive economies, capable of developing a satisfactory—and, in this case, highly desirable—degree of monetary cooperation and policy harmonization with one another. They are far less applicable to the exchange relations between larger countries, or groups of countries, which, because their external transactions are dwarfed by the size of their internal markets, are far better able to conduct effective monetary policies on their own, and are therefore far less interested and willing to subordinate their freedom of action to international consultation and effective policy harmonization.

Even in this case, however, the elimination of national currencies as an international reserve medium would remain a necessary prerequisite for the successful implementation and functioning of exchange-rate flexibility, particularly in the case of the present reserve-center countries.

H. *Whether and When?*

So-called realists will merely shrug their shoulders at the above proposals and dismiss them with the simple word: "Utopia!" They will prefer to "build directly upon the existing payments procedures to which governments and individuals are already well accustomed."⁴¹ In the words of Erich Fromm, "it is, indeed, one of the irrationalities of human nature that we are prone to seek for easier, short-term solutions because we are afraid of the difficulties of the fundamental and real solutions. But in individual as in social life, it is the logic of facts that determines reality, not the logic of wishful thinking."⁴²

This is why I have little doubt about the inevitability of a continued evolution of our international monetary institutions in a direction so

⁴¹ Robert V. Roosa, *op. cit.*, p. 12.

⁴² Erich Fromm, *May Man Prevail?* (New York, 1961), pp. 207-208.

clearly charted by the historical development of national monetary systems in every country of the world, and by similar trends already perceptible in the changing structure of the international reserve system itself over the last half century.

In every country, "commodity money" has been gradually displaced by "credit money" (see Tables in Appendix I). Credit money remained at first unorganized, and its creation—or destruction—abandoned to the uncoordinated decisions and policies of multiple issue and deposit banks. The instability of such a system prompted the development of national central banks. These did not replace and eliminate previous institutions, but assumed initially centralized clearing and reserve functions, out of which further instruments for policy coordination and orientation of bank credit and monetary expansion developed gradually over the years. As in the case of other human institutions, this evolution was rarely blueprinted in advance through conscious planning. It came, in most cases, as the unforeseen consequence of "short-term" expedients, adopted to meet pressing problems and crises, but which then developed a life of their own through the internal logic of institutional adaptation to man's changing environment.

Speaking of the development of the gold standard itself, Jacques Mertens noted that:

"Most of those interventions do not flow from any clearly planned monetary policy and objectives. In general, the authorities intervene only in case of difficulties, during periods of monetary troubles. Time is then of the essence, and action is most often limited to partial and temporary measures. . . . What emerges are compromise solutions along the path of least resistance, whose merit in the eyes of the administrators is that they do not commit them in the future, but leave them a free hand to determine later final decisions whose timing is always postponed. It has certainly been one of the most tenacious illusions of the executive power to believe that by postponing decisions, by cumulating temporary expedients and half-measures, it retained its freedom of action. Have we not seen, on the contrary, that repeatedly and without wishing it, administrations have put their finger in the cog and have found themselves dragged on, against their will, toward unexpected results by measures which they considered as totally secondary or purely temporary?"⁴³

The displacement of "commodity money" by "credit money," in national monetary systems, finds an exact parallel in the incipient, but fast growing, displacement of "commodity reserves" by "credit re-

⁴³ Jacques E. Mertens, *La Naissance et le Développement de l'Étalon-Or* (Louvain and Paris, 1944), pp. 358-357.

serves" in the international field. The proportion of credit reserves to total reserves has grown, for the countries of the Paris Club, from about 3 per cent in 1885 and 7 per cent in 1913 to 13 per cent in 1949, 21 per cent in 1957, and 28 per cent in 1962 (see Table 6 in Appendix I).

For the world at large, but excluding the two reserve-center countries of the gold-exchange standard, credit reserves totalled, in September 1963, \$26.7 billion out of total reserves of \$48.1 billion, i.e., more than 55 per cent, as against less than 45 per cent for gold itself.⁴⁴

While the bulk of these credit reserves are still in the form of national currencies, a modest but growing portion is already held in the form of deposits with the IMF—under the name of "gold tranches,"—and national currency holdings themselves are becoming stabilized, little by little, by informal agreements, such as those long in effect in the sterling area and those more recently negotiated by the United States with the major dollar holders of Western Europe.

The main question facing us is not whether this evolution will continue over the sweep of history, but whether the international agreements necessary to that effect will be negotiated in time to avert further crises, such as that which swept away nearly overnight the "credit component" of the 1931 international reserves and brought about a protracted collapse of the international monetary system.

⁴⁴ Calculated from pp. 15, 17 and 18 of the February 1964 issue of *International Financial Statistics*.

IV. NEGOTIATING PROSPECTS FOR 1964

The prospects for a basic, and long overdue, overhauling of our international monetary system have improved vastly over the last two years. The awakening of responsible monetary officials to the full magnitude of the problem that faces them was a gradual process, but has in fact been faster than could have been reasonably anticipated in, let us say, September 1960, on the eve of the London gold crisis. While President Kennedy and Prime Minister Macmillan should be given full credit for having first called attention to the need for boldness in this field,⁴⁵ the Maudling Plan embodied the first concrete suggestions for negotiating action. Presented at the 1962 Annual Meeting of the IMF, it was cavalierly cold-shouldered by most of Chancellor Maudling's colleagues at that meeting.

Yet, other proposals were gradually developing, both in the United States and in Europe. Under Secretary Roosa's article on "Assuring the Free World's Liquidity,"⁴⁶ while negative in many respects, admitted the need for long-run reform, and argued for the expansion of monetary reserves through mutual currency accumulation by all the leading countries, including the United States. In Europe, the Monetary Committee of the European Economic Community devoted many sessions to the discussion of the Posthuma Plan⁴⁷ and of other suggestions aiming at the development of a joint approach to the problem by the countries of the Community.⁴⁸

A major breakthrough was finally announced at the last Annual Meeting of the IMF, in October 1963. Mr. Pierre-Paul Schweitzer, Managing Director of the Fund, announced in his opening statement that: "In the coming year the Fund will develop and intensify its studies regarding international liquidity, the functioning of the inter-

⁴⁵ See President Kennedy's *Message to Congress on the Balance of Payments and Gold* (February 6, 1961); the *United States Aide Mémoire on the Balance of Payments Situation* (February 20, 1961); and Prime Minister Macmillan's speech at MIT in April 1961. Relevant excerpts are quoted in *Gold and the Dollar Crisis* (1961 edition), pp. 179-181, and in "The Gold Exchange Standard: Crisis and Reconstruction," *Amerikanische Gelehrtenwoche* (Munich, 1962), p. 213.

⁴⁶ *Business Review Supplement*, Federal Reserve Bank of Philadelphia, September 1962.

⁴⁷ See S. Posthuma, "The International Monetary System," *Banca Nazionale del Lavoro Quarterly Review*, September 1963; and "Wandlungen im internationalen Währungssystem," *Kieler Vorträge* (Kiel, 1963).

⁴⁸ *Mémorandum de la Commission sur le Programme d'action de la Communauté pendant la deuxième étape* (Bruxelles, 1962), pp. 75-80.

national monetary system, and the effective role of the Fund in this field." A few days later, Mr. Dillon, Secretary of the Treasury of the United States, issued a "Statement on Behalf of the 'Group of Ten' Members of the Fund," in which the Ministers and Central Bank Governors of the ten countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States) announced the launching of a high-level and "thorough examination of the outlook for the functioning of the international monetary system and of its probable future needs for liquidity."⁴⁹

This examination formally ruled out from the start the two "false solutions" of the problem—an increase in the price of gold, or the adoption of flexible rates—the rejection of which constituted the first chapter of my own "Prescription" in *Gold and the Dollar Crisis*.⁵⁰ Representatives of the major countries concerned—and of the IMF—have also indicated that new solutions should be sought in *multilateral* arrangements, rather than in any considerable extension of the *bilateral* agreements concluded in recent years.

Behind this surface of agreement, one could detect, however, significant differences of viewpoint and emphasis, particularly between the currency-reserve debtors—primarily the United States and the United Kingdom—and their creditors.

The key-currency debtors tend to emphasize the inadequacy of gold production to satisfy future liquidity requirements in an expanding world economy, rather than the weakness of their own monetary position. They would like this gap to be met through agreed limitations on gold holdings, and the continued use of national currencies—particularly their own—as normal media for reserve accumulation. They are also reluctant, however, to concede that gold or exchange guarantees are in any way useful or necessary to extract from reserve holders firm and long-term commitments against sudden or massive conversions of reserve holdings from one currency into another or into gold.

The major reserve holders—and reserve-currency creditors—of continental Europe, on the other hand, consider as still relatively remote the danger of a worldwide liquidity shortage. They suspect in the liquidity thesis a convenient cover for an attempt of the United States and the United Kingdom to elicit from surplus nations an advance underwriting of future deficits, relieving the deficit countries from harsh, but healthy, balance-of-payments disciplines. They would also welcome greater equality and reciprocity in any arrangements regulating the future composition of world reserves. Any ceiling on gold

⁴⁹ See *Summary Proceedings, Annual Meeting 1963, International Monetary Fund*, pp. 30 and 285-286.

⁵⁰ Pp. 79-86.

holdings, for instance,—in relation to each country's total reserves—should apply to the United States and the United Kingdom—which traditionally hold their reserves almost entirely in gold—as well as to the continental countries, most of which already keep a high proportion of their reserves in foreign exchange. Reciprocity should imply the eventual use of continental currencies, and not only of dollars and sterling, as international reserves. Finally, some gold or exchange guarantees are regarded as a well-nigh indispensable feature of any agreement consolidating the use of national currencies as international reserves, and limiting their free convertibility into gold.

Recent official speeches and comments—before, during, and after the last IMF meeting—give reasonable grounds for hope that these initial divergencies of negotiating positions and approaches will yield to the logic and realities of the basic problems to be solved. The French Minister of Finance, Giscard d'Estaing, was particularly blunt and candid in expressing the European point of view at the IMF meeting, but the very conditions which he outlined implied a willingness to face the real issues and to limit the creditor countries' present rights to gold accumulation and gold conversions.⁵¹ On the other hand, Under Secretary Roosa envisaged, more than a year ago, substantial accumulation of foreign currencies in the future by the U.S. monetary authorities, Chancellor Maudling suggested—also more than a year ago—mutual reserve holdings backed by full gold-exchange guarantees, and Secretary Dillon has now agreed⁵² that exchange guarantees would be a proper, and probable, topic for discussion by the Group of Ten.

It is, further, extremely probable that the initial search for agreements will focus primarily on the more urgent, and universally recognized, problem of consolidating the foreign-exchange component of existing reserve levels, rather than on the more controversial and less immediate issues raised by the desirable rate of expansion of world liquidity in future years.⁵³

⁵¹ See particularly pp. 60 and 61 of his statement in the *Summary Proceedings* quoted above.

⁵² As indicated in answer to a blunt question, in the course of his press conference of October 2, 1963, at the IMF Meeting.

⁵³ I have suggested elsewhere as most urgent and immediately negotiable the consolidation of outstanding reserve-currency balances into longer-term "reserve certificates," excluding unnecessary conversions into gold metal, but protected by adequate exchange guarantees and fully transferable for all balance-of-payments settlements insofar as such transfers would be conducive to a more—rather than a less—uniform proportion of gold and certificates in member countries' overall reserves. See, for details, Section II A of the article quoted below, footnote 57, p. 47. This suggestion was *unanimously* endorsed last January by academic econo-

Yet, it will be difficult to elude entirely the question of the proper role to be assigned to reserve-currency countries' deficits in the present, and future, process of reserve creation. If a ceiling is to be placed on gold accumulation, as a proportion of total reserves, in order to avoid a deflationary scramble for gold, should not some ceiling be placed also on the accumulation of national currency reserves, in order to limit inflationary excesses in world reserve creation? Secondly, to the extent that the need for future increases in credit reserves is recognized, and that reserve holders accept definite commitments in this respect—in the form of a maximum ratio of gold to global reserves, for instance—they will also have to decide on the distribution of such credit-reserve accumulation as between dollars, sterling, other national currencies, and/or claims on the IMF and other multilateral monetary institutions.

Some automatic formulas have recently been proposed in this respect by Dr. Posthuma⁵⁴ and Dr. Bernstein,⁵⁵ in order to escape the need for international, or supranational, decisions, imposing unwanted disciplines on national monetary authorities. I doubt whether such total surrenders of sovereignty to any automatic formula would be more acceptable to central banks, in the long run, than the limited mergers of sovereignty involved in joint, international decisions, as have long been traditional in the operations of the IMF, EPU, etc. Jointly decided credit transactions of this sort have long been, moreover, and will remain, a powerful stimulus to the harmonization of national policies, necessary to promote long-run equilibrium in the countries' balances of payments. As to the discipline imposed thereby on individual countries, it is itself desirable if harmonization is to be achieved, and can in any case be rejected—together with the proffered assistance—by any country which deems it nationally unacceptable. It is certainly difficult to conceive of a system under which any country should, or would, be guaranteed automatic access to international lending, on any substantial scale, to support policies which the lenders deem disruptive of international equilibrium.

Finally, major reserve holders—particularly in continental Europe—are likely to insist upon retaining a closer degree of control over the investment of their credit reserves than would be compatible with present—or negotiable—patterns of voting rights in the IMF Executive Board. This is the major consideration underlying the setting up, in

mists representing all shades of opinion regarding the long-term objectives of international monetary reform.

⁵⁴ See, above, references in footnote 47, p. 43.

⁵⁵ "A Practical Program for International Monetary Reserves," *Quarterly Review and Investment Survey*, Model, Roland and Co., New York, Fourth Quarter, 1963.

October, of two separate explorations of the problem: one by the IMF and another by the Group of Ten. There is every reason to hope, however, that the ultimate conclusions of these two inquiries will be fitted together in a manner which reconciles the legitimate interests of the Ten with those of other countries, and integrates the policies and institutions of the Ten within the broader framework of a reformed, and more decentralized, IMF machinery.⁵⁶

I have discussed in a separate paper⁵⁷ some concrete negotiating suggestions relative to these various points and to the prospective initial area of agreement that might emerge from recent and current discussions among the Ten, and more particularly among the countries of the European Economic Community. These suggestions fall far short, of course, of the broad, long-range perspectives outlined in Section III above and which could hardly serve as a "take it or leave it" scheme for realistic agreements, negotiable in the near future. Major adaptations and adjustments are undoubtedly necessary to that end, but should be molded in such a way as to keep the door wide open to the future evolution of the system.⁵⁸

⁵⁶ Broad readjustments of IMF quotas, and greater flexibility of access to the Fund—particularly through the enlargement of present gold tranches—are indeed among the most predictable results of the current explorations. If they were to be the only ones, flowery press releases on such a meager achievement should be regarded as mere "face-saving," disguising the utter failure to reach the broader objectives of the negotiations now in process.

⁵⁷ "The Problem of International Monetary Reform: Major Questions and Prospective Initial Area of Agreement," *Banca Nazionale del Lavoro Quarterly Review*, March 1964.

⁵⁸ Comprehensive and rigid agreements at the Tokyo meeting itself might indeed be unfortunate from this point of view, if they contributed to a premature crystallization and freezing of the limping solutions most likely to prove negotiable at the present juncture. More modest, and even temporary, but flexible, agreements might be far preferable, particularly if complemented by the creation of some high level *consultative* group, entrusted with the exploration and orientation of the future measures and negotiations that will be required for continuing and evolutionary adjustments of the international monetary system to actual needs and possibilities.

The experience of the EPU Managing Board, of the Rome Treaty negotiations, and of the European Economic Community suggest that later agreements would be greatly facilitated if the members of such a group were designated *jointly* by the countries concerned—rather than separately appointed by national governments—and freed from any unanimity rule in the presentation of their reports and recommendations. Such a technique would permit a much freer exploration of alternative solutions which national representatives, tied by their "instructions" from the home governments, would often be unable to suggest, or bound to oppose. Final action would, of course, still require in most cases the unanimous approval of the governments concerned, but the deliberations of the national decision-making bodies would be far better enlightened and guided regarding the full range of alternative solutions theoretically available and the actual

The first of these adjustments would be to limit to a jointly agreed proportion of total reserves the amounts that should be kept in the form of deposits with the Center, leaving each country free to retain the remainder of its reserves in gold metal if it wished. Such a system of compulsory reserve requirements would be operated through the IMF, and could indeed be *substituted* advantageously for the present capital subscriptions to the Fund in such a way as to provide it with a roughly equivalent amount of lending resources. Such a system would present two advantages over the present haphazard and rigid quota system of the Fund. It would, first of all, express in a more obvious and traditional form—that of reserve deposits—the fully liquid character of the claims now accumulated on the Fund in the form of “gold-tranche” capital subscriptions. Secondly, and foremost, it would continually adapt the pattern of Fund resources to the contributive capacity of each member, and to the actual payments surpluses that the Fund may be called upon to finance. It would dispense, for that reason, with the necessity of periodic adjustments in members’ lending quotas.

A second area of adjustment would recognize the need for greater decentralization in the IMF machinery, and for the encouragement of closer monetary cooperation and responsibility on a regional scale, under the general aegis of the Fund.⁵⁹

A third, but more unfortunate, area of compromise, is likely to consist in the retention of national currencies as a major component of credit reserves, in lieu of IMF deposits, and in the addition of currencies other than sterling and the dollar to the list of reserve currencies. This would perpetuate, and might even aggravate, the major source of instability of the present system, except to the extent that the accumulation—or liquidation—of such holdings would be regulated through *joint* decisions of the main reserve holders, or the application of automatic formulas, à la Bernstein or Posthuma. Such automatism, however, hardly seems viable in the long run, and would waste the Godsent opportunity that joint decisions in these matters

chances of reaching international agreement—or a paralyzing deadlock—on any of them.

⁵⁹ For further discussions and concrete suggestions, see for instance: Robert Triffin, *Europe and the Money Muddle* (Yale University Press, 1957), pp. 137-138, 177-179, 256-268 and 280-294; *Gold and the Dollar Crisis* (Yale University Press, 1960), pp. 119-144; “Intégration économique européenne et politique monétaire,” in *La Restauration des Monnaies Européennes* (Special number of *Revue d’Economie Politique*, Paris, 1960); “Toward a Latin American Monetary Organization,” in a forthcoming volume of Miguel S. Wionczek, ed. (Harvard University Press, 1964); and Pierre Uri, *Partnership for Progress* (New York: Harper and Rowe, 1963), pp. 96-107, particularly p. 103.

would offer for the harmonization of national policies essential to the long-run payments balance of the member countries.

The main arguments offered in favor of undesirable compromises of this latter kind are derived from a misplaced attachment to customary procedures, an instinctive fear of untried innovations, and nationalistic resistance to an institutional recognition of the factual interdependence of so-called sovereign countries in this atomic age of ours.

Bureaucrats, diplomats, and statesmen might ponder with profit, today more than ever, one of the most poetic pages of Maurice Maeterlinck:

"At every crossway on the road that leads to the future, there stand a thousand men appointed to guard the past. Let us have no fear lest the fair towers of former days be insufficiently defended. The least that the most timid among us can do is not to add to the immense dead weight which nature drags along.

"Let us not say to ourselves that the best truth always lies in moderation, in the decent average. . . . The average, the decent moderation of today, will be the least human of things tomorrow. At the time of the Spanish Inquisition, the opinion of good sense and of the good medium was certainly that people ought not to burn too large a number of heretics; extreme and unreasonable opinion obviously demanded that they should burn none at all.

"Let us think of the great invisible ship that carries our human destinies upon eternity. Like the vessels of our confined oceans, she has her sails and her ballast. The fear that she may pitch or roll on leaving the roadstead is no reason for increasing the weight of the ballast by stowing the fair white sails in the depths of the hold. They were not woven to molder side by side with cobblestones in the dark. Ballast exists everywhere; all the pebbles of the harbor, all the sand of the beach, will serve for that. But sails are rare and precious things; their place is not in the murk of the well, but amid the light of the tall masts, where they will collect the winds of space."

CANADIAN TRADE COMMITTEE



***THE INTERNATIONAL
MONETARY SYSTEM:
CONFLICT AND REFORM***

THE PRIVATE PLANNING ASSOCIATION OF CANADA

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The Private Planning Association of Canada is a private, non-political, non-profit organization established in 1958. It was created for the purpose of undertaking independent and objective study of Canadian problems and policies, mainly in the fields of economic affairs and of Canada's international relationships with other countries.

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The International Monetary System: Conflict and Reform

by Robert A. Mundell

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■ The Canadian Trade Committee

The Canadian Trade Committee was established in 1961 to study Canadian trade problems and policies. Its membership comprises approximately 50 business, labour, agricultural and professional leaders who are broadly representative of different regions of the country and different sectors of the economy. The Committee is sponsored by the Private Planning Association of Canada — a private, non-profit research company established in 1958 to undertake objective studies on issues of national importance.

At the first meeting of the Committee in January 1962, the Committee agreed that rapidly changing international trading conditions were creating new challenges and opportunities for Canada as one of the world's greatest trading nations. It was also agreed that Canada's international trade had historically played a prominent role in promoting the economic growth and development of the country and in achieving the present high standard of living of its people. The maintenance of a strong trading position was considered to be a vitally important requirement for Canada's future prosperity and growth.

In the light of recent and prospective international economic developments, the Committee concluded that a careful reappraisal of Canada's trading position and commercial policy was necessary. The Committee therefore decided to study Canada's current and prospective trading problems, and to develop factual information which can be made publicly available. The primary objective is to create wider public understanding of these problems in their proper perspective, and to develop appropriate conclusions in Canada's national interests regarding adaptations in international economic policies to fit changing world conditions.

To achieve its aims the Committee is sponsoring a series of objective and comprehensive research studies on various aspects of Canada's trading position. These studies are prepared for the Committee by qualified experts and are usually published following Committee authorization.

On the basis of these studies and of discussions at its meetings, the Committee also, from time to time, issues policy statements on a number of subjects. These statements, signed by members, seek to increase public understanding in Canada about the attitudes, policies and actions which are in Canada's essential commercial interests.

The Committee meets at least twice a year. An Executive Committee has been established with general supervisory authority for the research program, and subcommittees are organized to explore particular research projects. The Committee's work is financed by funds contributed from private sources in Canada.

H. Edward English is the Committee's Director of Research. The office of the Committee is maintained at the Private Planning Association of Canada, 712 Sun Life Building, Montreal 2, Quebec.



Chairman of the Committee

■ **Statement**
by the Canadian Trade Committee
on "The International Monetary System:
Conflict and Reform"

Ever since the breakdown of the gold exchange standard in 1931, there has been a continuing effort to build an effective managed monetary system. New international institutions—especially the International Monetary Fund—have been established, and cooperative arrangements between national central banks have evolved. This system has, however, been subjected to severe strains arising from the increasing role played by key currencies (particularly the United States dollar and the British pound) as international reserves, partly as a consequence of the limited supply of gold. The national economic policies of countries issuing reserve currencies have not always corresponded with the policies which countries holding key currency reserves have considered appropriate for the preservation and strengthening of the present international monetary arrangements. For both economic and political reasons these other countries have called for a new, and more truly international, monetary system.

In the present study, which the Committee has authorized for publication, the author reviews the history of the search for solutions to the international monetary problem in all its aspects—the liquidity problem, the adjustment problem, and the confidence problem. He discusses the advantages and disadvantages of the gold standard system and of the system based on the International Monetary Fund, as well as the merits of flexible exchange rates and the proposal for an international central bank. The author acknowledges that any practicable solution must take into account the current political realities, but at the same time urges that those who have the responsibility for dealing with immediate problems or crises should endeavour to design and adopt measures which contribute to longer-term solutions of world monetary problems. In this context he develops a proposal for combining some of the advantages of the gold standard and limited exchange-rate flexibility.

The Committee has been fortunate in obtaining the services of Dr. Robert A. Mundell, who is currently associated with the Brookings Institution in Washington, for the preparation of this report. The views expressed are those of the author, who assumes full responsibility for them, and they do not necessarily reflect the views of the Committee or of individual members of it. The Committee feels, however, that the report makes a useful contribution to an understanding of complex issues associated with the international monetary system.

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■ Preface

This monograph originated in a talk given to the Canadian Trade Committee on December 12, 1964. In the course of preparing it for publication I have benefited considerably from the specific advice and friendly criticisms of Walter S. Salant, Harry G. Johnson, Eugene A. Birnbaum and H. Edward English. Also I should express general appreciation to my colleagues at the Bellagio-Princeton conferences organized by Fritz Machlup, where the interchange of contrasting ideas was a fruitful source of inspiration. And finally, I should record my indebtedness to Robert Triffin for posing the general problem in a form no international economist could ignore. Almost needless to say on such a controversial subject, none of the above economists necessarily share my approach to the basic issue.

I wish to dedicate this book to my mother and father.

ROBERT A. MUNDELL

CHAPTER 1

■ Introduction

For half a century the world has been plagued by international monetary instability. This is hardly surprising. Monetary disorder is a concomitant of political chaos, and no age in history has surpassed ours in that. No international monetary system is warproof and no conventional structure can survive in an age of blind economic nationalism.

Money is meant to be servant, not master, and international monetary arrangements should reflect the times rather than determine their character. This was the case during the relatively tranquil days of the pre-1914 gold standard, when political stability coincided with monetary stability. It was also true in 1914, as the gold standard succumbed with the outbreak of war; and again, during the relatively tranquil 1950s, when the political and economic hegemony of the United States was unchallenged in the West, and the dollar was "as good as gold".

But sometimes money is master after all, as in 1931. Who would deny the significance of the monetary crisis in that year in opening the doors to Hitler in Germany, in spreading fascism through Eastern Europe, and in aggravating the weakness of the democracies? The events leading up to that crisis should be recalled to mind.

In the summer of 1931 an Austrian bank failed. This resulted in a wholesale withdrawal of funds from Central Europe and caused a banking crisis in Germany. To protect the Reichsmark, the German discount rate was put up to fifteen percent and exchange controls were imposed. British bank assets in Germany were thus immobilized and a speculative withdrawal of funds from London began. Confidence was undermined. The Bank of England sought and obtained credits from the Bank of France and the Federal Reserve, but these were quickly exhausted without stemming the tide. Further credits were sought, but offered by the French and Americans only with unacceptable strings attached. The British government fell, and on September 19 sterling was cut loose from gold.

The aftermath is well known. One currency followed the other in the plunge toward exchange-rate chaos; trade and exchange restrictions proliferated throughout the world; and tighter monetary policy followed in the United States. The depression was intensified, and economic warfare began to characterize the times.

We have learned something from that tragic episode of monetary chaos. Among the lessons is how an apparently minor event can generate a chain reaction throughout the world when the foundations of the international monetary system are shaky. As the IMF put it in its 1958 report on liquidity:

. . . once a crack starts in the exchange structure it is difficult to limit its effects. It may lead to the forced devaluation of major currencies — devaluations not dictated by the realities of foreign trade and competitive prices. Such a crack may start with a relatively minor currency, and yet gain such momentum that it ultimately sunders the whole international exchange structure.

We have learned what *can* happen, but astonishingly, we cannot be sure that monetary officials have learned how to *prevent* it from happening. International monetary developments today bear many striking similarities to events leading up to the 1931 collapse. The weaknesses inherent in the gold exchange standard today are not fundamentally different from the weaknesses of the system built up in the 1920s.

The stability of the gold exchange standard of the 1920s depended upon the acquiescence of creditors in protecting the reserve positions of the major key currency, at that time the pound sterling. That acquiescence, initially agreed by most powers, was soon withdrawn. England was partly to blame for going back to gold in 1925 at an overvalued rate for sterling. America was partly responsible for sterilizing gold inflows in the later twenties. But France sealed the fate of the system by the now-famous sequence of first undervaluing the franc (in 1927) and then requiring (a year later) that only gold would be accepted in settlement of the enormous surplus that developed as a consequence of the undervaluation.

The security of the system today once again depends upon the safety of the reserve currencies, the dollar and sterling. The present system could prevail if foreign central banks were committed to retention of dollar balances accumulated in exchange-market stabilization activities. But central banks are not so committed, except insofar as it suits their self-interest, and the system is once again insecure.

France, in 1965 as in 1928, has again served notice that it intends to bring to an end the gold exchange standard if it can. General de Gaulle has attacked the special status of the dollar and sterling and announced a policy of taking nothing but gold in settlement of international transactions, at the same time urging other countries to cooperate with France by following suit. The spectre of a collapse of the system is therefore again upon us, and for precisely the reasons a collapse occurred more than thirty years before. History could repeat itself.

Whether it will depends on the behaviour of monetary officials. France might try to achieve the maximum embarrassment of the U.S. monetary authorities in the belief that this will enhance her political stature vis-à-vis the United States and the rest of the world. But it does not correspond to French interests to bring about a collapse of the system; doubtless French leaders are aware that all pressure on the U.S. position must stop short of forcing a fundamental change in U.S. gold policy. The United States has the last trump, and miscalculated pressure on the part of France or other surplus countries might induce the U.S. authorities to play it. A bluff, after all, is of no further value after it has been called.

The risks of collapse, therefore, are not so much the risks of any nation deliberately trying to destroy the system. They are, rather, analogous to the risks of war: crisis by miscalculation. It is dangerous to press monetary authorities too hard and to attach unpalatable strings to lending in a crisis, because the alternative of abandoning gold may turn out to be less unpleasant in reality than acquiescence to the strings. As already noted, both the United States and France overestimated the reluctance of the United Kingdom to abandon gold in 1931. England had the last trump, and France and the United States miscalculated with respect to the ability of the British to play it, and their own willingness to see it played. As a consequence of the miscalculation, the rest of the world paid a high price.

The same danger of collapse by miscalculation exists today. In the 1964 sterling crisis Continental bankers successfully attached strings to their support for sterling; this time they did not miscalculate, and both the United States and Britain acquiesced by raising interest rates. The next time they may miscalculate; the U.K. or U.S. authorities may prefer to withdraw from the gold or exchange markets altogether rather than acquiesce in foreign monetary demands, and thereby force the would-be lenders to choose between continued lending or appreciation of their own currencies.

The danger of crisis by miscalculation is reinforced by the symptoms of monetary disorganization that have appeared since 1960. The 1960 gold bubble persisted because communications broke down between London and New York; the 1961 mark and guilder appreciation touched off perverse inward speculation and prepared the stage for the summer weakness of the pound; the 1962 dollar crisis in Canada followed depreciation and devaluation; the 1963-64 lire deficit was financed by the country (the United States) supposed to have the largest apparent *deficit*; the 1964 sterling crisis was relieved, not by surtaxes or a seven percent bank rate or IMF borrowing but by *ad hoc* borrowing outside normal channels; and as already noted, the French have moved unilaterally and deliberately to challenge the position of the reserve currencies.

The danger of crisis by miscalculation is not, however, limited to miscalculation by the "surplus" countries; it could also arise in a different form from mistakes on the part of the reserve countries themselves. Other countries may accumulate dollars or sterling because they *want* to enlarge their reserves and to hold them in London or New York in liquid earning assets. If, however, the reserve countries regard dollar and sterling acquisitions solely as a threat to their gold positions, and not as an ordinary accumulation of assets most countries want, the reserve centres may themselves act like deficit countries, pursue restrictive trade and financial policies, and bring deflation or devaluation upon the rest of the world.

This danger is pressing today in view of the current U.S. attitude to the accumulation of liquid dollar assets by foreign central banks and private holders, and the quaint U.S. method of defining the deficit in her balance of payments. Whereas countries outside EEC have given every indication that they *want* most of the reserves they have acquired, the United States has tried to limit acquisitions by *all* countries through the tying of aid, costly military procurement policies, restrictions on capital flows, and increased covert protective measures. The United States has, moreover, followed a far more restrictive monetary policy than was appropriate for a country with excessive unemployment, and this policy has cost the United States and her trading partners dearly. It is difficult to see how any country in the free world has benefited from the excess unemployment of the U.S. economy in recent years, and it is not even clear that the balance-of-payments policies imposed up to the end of 1964 have appreciably reduced the "deficit" as it is defined by U.S. officials. There is every evidence that the United States has miscalculated by allowing the fiction of an arbitrary accounting definition of her balance of payments,¹ quite remote from one which reflects her true financial strength in the world, to condition U.S. economic policy and even international political attitudes. It is not just the old matter of the "tail wagging the dog"; the problem is that the tail has been confused with the dog.

The deficiencies in the international system do not mean, of course, that the problems have passed without notice. On the contrary, plans for international monetary reform have multiplied in an exasperating way. Professor Triffin wants a form of world central bank. Professor

¹ The United States counts, as part of the deficit, not only the gold loss but also the increase in short-term liabilities to private holders and foreign monetary institutions. The Bernstein Committee's recommendations would be an improvement because they exclude from the definition the additional claims of private holders, but they remain defective because they continue to count the additional claims of official holders, implying that the dollar is less than a full-fledged international reserve asset.

Friedman wants a system of flexible exchange rates. Sir Roy Harrod wants an increase in the price of gold. General de Gaulle and Professor Rueff want to go back to a version of the gold standard. Robert Roosa wants a multiple-currency standard. E. M. Bernstein wants a composite reserve unit. And Kaldor and others want a commodity reserve standard.

These possibilities by no means exhaust proposals that have been suggested. Compromises of almost every conceivable kind have been discussed: to widen the exchange margins or to narrow them; to raise the price of gold or to lower it; to make exchange rates more adjustable or less adjustable; for more lending or for less lending; and so on. It is fair to say that the fifty-seven odd varieties of proposed solutions have not helped to inspire confidence that any will be chosen to rectify the defects of the existing mechanism.

Here, then, is the dilemma. There is fairly general agreement, among bankers, economists and officials, that the system contains fundamental weaknesses, that these weaknesses may grow over time, and that the result may be a major crisis, damaging to the whole free world. There is also a vast range of proposals to reform the system but no agreement on the direction reform should take and no prospect of major reform in the near future, despite the fact that such reform is necessary if crisis by miscalculation or design is to be averted.

The proposals that are technically feasible seem not to be politically acceptable, and those that are politically acceptable seem not to meet the problem. No substantial progress has been made toward fundamental reform of the system either in the Group of Ten meetings or in the IMF. And, in a sense, no progress can be made. Conferences confined to economic discussions are not likely to succeed when the real political issues are unresolved. The consequence is paralysis.

Faced with paralysis of the capacity to avoid crisis, and with the possibility (not to say probability) of catastrophe, we have no rational course other than to prepare for crisis. We need to minimize the threat that a crisis will end in catastrophe. We need to prepare for contingency action in the event of a crisis, in order to make the best of it.

Crisis action can have permanent effects on the evolution of the international monetary system. On choosing among alternatives, it is not enough to look at the short-run effectiveness of particular actions in saving the system, for some actions may postpone indefinitely the attainment of long-run solutions. Preparation for crisis ought therefore to involve investigation of the long-run consequences of current action. What sort of financial arrangements between countries can we expect to develop in the course of the next two decades? What actions brought about during a crisis will hasten or inhibit those arrangements which ap-

pear to be desirable? Our goal must be to find emergency actions that will hasten, rather than frustrate, desirable long-run solutions.

The following discussion starts out in that spirit. It is my conviction that the dollar standard that prevailed after the second world war was an effective standard, conducive to the rapid expansion of international trade and payments and consistent with the economic goals both of the United States and of the countries using the dollar as international currency and the New York market as a source of capital. A dollar standard remains the best system for a large number of countries despite the gold problem with which the United States has recently been faced, just as the sterling standard remains the best system for countries closely associated with the United Kingdom. Action necessary in a crisis should therefore be consistent with retention of the dollar and sterling as reserve assets for some countries regardless of the nature of reform of the international monetary system likely to result.

For other financial centres that now exist or are developing, however, the dollar may be unsatisfactory as a reserve asset. A new gold bloc is developing on the European continent, and bankers there have expressed a wish to eliminate the special status of the dollar and also of sterling, as a legitimate defense of what Europeans, rightly or wrongly, consider to be their vital financial interests. Crisis action should not therefore prejudice the possibility of the Europeans forming their own common currency to compete with the dollar and sterling as a reserve asset. The financial needs of much of Europe and a large part of Africa may ultimately be served best through the regional facilities of a new European international capital centre, just as the needs of the sterling area are served through London. While the analysis below leads, alas, to another plan, it has at least the merits of taking adequate account of the financial centres that exist and are developing, and of merging action that would be desirable in a crisis with action that will promote a desirable long-run evolution of the international financial system.

The plan is a simple one. In a crisis the United States should substantially widen the gold points (the maximum permissible spread between buying price and selling price of gold), after a consultation with the IMF, in order to make gold and the dollar less perfect substitutes. This initially would lead to a dollar standard, since countries currently peg to the dollar rather than gold, and gold might become a less safe asset for countries whose currencies continue to be pegged to the dollar. But eventually, as the strength of the Continental bloc grew and facilities became better organized for the provision of a reserve asset (which I shall call the 'thaler') emanating from the EEC, the EEC will be able to peg to gold rather than to the dollar, as countries are permitted to in the Fund Agreement. This would mean that exchange rates between the

thaler area and the dollar area would be able to fluctuate within the limits permitted by the new gold margins. In short, the system would become a gold standard system with exchange-rate flexibility between wide buying and selling limits.

Countries in the dollar area would hold reserves in dollars, while the United States would hold the external reserves of the area in gold. Countries in the thaler area could hold reserves in the new thaler, while the EEC would hold the external reserves of the area in gold. The same would be true for the sterling area, which may, however, develop a closer association with either the dollar area or the thaler area depending on the course of international political developments.

This system would at the same time not prejudice the long-run development of a world central bank if the need arose and if political developments permitted it. But there is little or no possibility of expanding the IMF into a world central bank in the current state of international financial relations, recently characterized by Prime Minister Wilson as a "monetary war". At the present stage of international developments it becomes necessary to recognize the *fait accompli* of financial centres, and to find ways of organizing pacific financial relations between the centres without jeopardizing the usefulness of the reserve currencies that now exist or may develop.

The following discussion examines the tasks of the international financial system, the present defects which threaten its stability, and the foundation one can find in law for establishing a gold standard system between the major financial centres based on substantially widened gold points.

CHAPTER 2

■ The Tasks of the International Monetary System

The international monetary system is the setting in which trade, aid, and lending are conducted between countries possessing different currencies and pursuing different national policies. It has three tasks to perform. It should provide sufficient expansion of international money to finance the growth of trade and payments. It should contain an efficient and equitable mechanism for equilibrating balances of payments. And it should ensure, if there is more than one kind of international money, that sporadic shifts from one kind of international money to another do not destroy confidence in their exchange values. The three main problems associated with these functions have come to be called the *liquidity problem*, the *adjustment problem*, and the *confidence problem*.

The problems are closely related. Balance-of-payments deficits can be financed or they can be corrected. The faster the deficits are corrected, the smaller are the reserves needed to finance them. The larger the reserves available, the less urgent it is to correct deficits. An attack on one reserve asset can cause a scarcity of liquidity, and an increase in total international reserves can affect the degree of confidence in any particular reserve asset. Also, the promptness of adjustment measures affects the supply of liquidity and the state of confidence, and both in turn can alter the distribution of the burden of adjustment.

Both individual countries and the world in the aggregate can face liquidity, adjustment, and confidence problems. An individual country faces a liquidity problem when its international reserves become inadequate, an adjustment problem when it has to correct a deficit, and a confidence problem when the value of assets denominated in its own currency becomes insecure. Some of these problems facing an individual country will be taken up in the next section.

From the standpoint of international monetary reform, however, it is the international counterparts of the three problems that are overriding. Every country must see to it that its balance-of-payments disequilibria are eventually corrected; but because balances of payments are interrelated, the deficits of some countries constituting the surpluses of others, there is an international problem of specifying the desirable distribution of adjustment between countries. Each country, similarly, will typically try to acquire needed reserves, but whether or not all countries can do so is an international problem because the total reserves that all countries together can hold must be equal to the total reserves available. And each country will try to maintain confidence in its own cur-

rency, but the ability of the reserve centres to do so will depend on the individual policies of other countries in determining the composition of their own assets.

A. National Choices

USE AND COST OF RESERVES

Politics aside, countries want to hold reserves because they do not have, or do not want to use, quick methods of correcting balance-of-payments deficits. The monetary authorities recognize the probability of future deficits which they cannot correct instantly and so they prepare their financing in advance by holding reserves. The more reserves they own, and the more access to borrowing they have, the greater the freedom they have in choosing among different methods of adjustment at some future time. A country in a liquid position has considerable choice over the type, pace, and timing of adjustment, whereas a country that is illiquid has little choice.

The advantage of holding reserves stems from the convenience that a wide choice of adjustment techniques offers. But reserves can be held only at a cost, so countries want to hold only limited quantities. Allowing for the interest that can be earned on certain types of reserves, the cost of holding reserves is the loss of the use of real resources given up by accumulating reserves, and can be measured by the return that could be earned by investing the reserves in real assets. The gain from holding reserves generally declines as the quantity of reserves increases, while the cost of holding reserves itself bears a real cost in terms of foregone resources.

Any country's *actual* level of reserves depends on *past* balance-of-payments *surpluses*; and the *desired* level of reserves depends on (expected) future balance-of-payments *deficits*. When a country's reserves are considered excessive, it tries to get rid of reserves by stimulating their investment in other assets; and when a country's reserves are considered deficient, it tries to acquire more. In all these respects, the behaviours of a country with respect to its international reserves is very much like the behaviour of an individual with respect to his cash holdings.

ADJUSTMENT OF THE BALANCE OF PAYMENTS

Countries get rid of reserves or reduce their rate of increase over time by running deficits or reducing surpluses in their balance of payments. Possible ways to reduce reserves, or "adjust" to surpluses, include appreciating the exchange rate, allowing wages and prices to rise, adopting more liberal import policies, relaxing exchange controls, reducing

export subsidies. A country may adopt any combination of these measures when its stock of reserves is thought to be too large or when its reserves are increasing at too rapid a rate.

Countries acquire reserves, or prevent their decrease over time, by running balance-of-payments surpluses or eliminating deficits. To establish surpluses or "adjust" to deficits, they can devalue, lower wages and prices, tighten money market conditions, impose tariffs or quotas, introduce or tighten exchange controls, or any combination of these policies. A country will generally follow one or another of these policies when its reserves are considered deficient or falling at too rapid a rate.

Methods of adjustment today are generally "discretionary" rather than "automatic". It was not so under the gold standard; then currencies were directly attached to gold, and gold flows (in theory, at least) altered money supplies, interest rates, prices, and employment until a new equilibrium had been brought about. Nor would it be so under a system of flexible exchange rates, which would automatically preserve balance-of-payments equilibria by exchange-rate changes and would leave financial policies free for use in implementing other objectives such as full employment and domestic price stability.

Discretionary adjustment measures may or may not be efficient. Trade controls, tariffs, or restrictions on capital movements misallocate resources. Whether tight or easy money is efficient or not depends on the extent to which the monetary policy appropriate for external balance is consistent with that needed for full employment and price stability.

For a deficit country experiencing inflationary pressure, monetary contraction is clearly in order in the interest of achieving both external and internal balance; for a surplus country experiencing deflationary pressure, monetary expansion is desirable. But in other cases, monetary policy can be used effectively only when employed in concert with other policy instruments.

Thus, in a deficit country with unemployment, tight money might improve the balance of payments, but at the expense of employment; for a surplus country with inflationary pressure, easy money might have the desired effect on the balance of payments, but only at the risk of greater inflation. In these situations, exchange-rate depreciation (or devaluation) and appreciation (or revaluation), respectively, are preferred policies in the sense that they move both external and internal sectors toward balance.

If exchange-rate changes are, for some reason, ruled out, some other policy tool must be employed. One possibility is to split financial policy into its components of monetary and fiscal policy and use them separately for external and internal balance. Can this work?

The answer is that it can,¹ if monetary and fiscal policies have different effects on the balance of payments relative to their effects on the level of domestic expenditure. If the relative effects are different, the instrument which more strongly affects the balance of payments should be used for that purpose while the other instrument should be used to affect the level of employment.

Under present circumstances, largely because of the increased capital mobility that has developed since the convertibility of the European currencies, monetary policy (a change in interest rates) has a greater effect than fiscal policy on the balance of payments, assuming both policies have the same effect on aggregate demand at home. The two policies would have similar effects on the balance of payments too in the absence of international capital mobility, so that the extent to which they have different effects depends on the degree of capital mobility. Since capital mobility has recently become considerable, it then follows that an increase in interest rates combined with a reduction in the budget surplus (or an increase in the deficit) can move the economy back toward full employment and balance-of-payments equilibrium in the short run. Monetary policy has, so to speak, a "comparative advantage" in correcting the balance of payments, while fiscal policy has a "smaller comparative disadvantage" in correcting unemployment. To put it another way, a tighter monetary policy has a favourable effect on the balance of payments, and an easier fiscal policy has a favourable effect on the level of employment, while the unfavourable side effects of monetary and fiscal policy (on employment and external balance, respectively) are minimized. The "Central Bank" should therefore concentrate on the balance of payments while the "Treasury" concentrates on the level of unemployment. In any particular country, of course, the timing and lags associated with the use of each policy would have to be taken into account.

The combination of monetary and fiscal policy can be made even more effective if specific aspects of monetary and fiscal policies are emphasized. Instead of a general increase in government spending, there can in principle be a selective increase in spending, concentrating primarily on goods with a low import content. Government purchases of import goods need not be increased at all and may actually be reduced, while tighter monetary policy can emphasize those instruments (e.g., short-term interest rates) to which capital flows are most sensitive. To a certain extent it is also possible to increase the difference between domestic and foreign interest rates by central bank intervention in the forward exchange market, although this may be possible only in the very short run. In other words,

¹ A theoretical analysis of this point is given in the author's paper, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Balance", *IMF Staff Papers*, March 1962.

the specifics of monetary and fiscal policies can increase the distinctness of the two weapons and make their separation in policy more effective. At the same time it must be recognized that specific policies, as opposed to general ones, can give rise to other distortions (they can, in fact, amount to various forms of hidden protectionism) and introduce an undesirable element of arbitrariness in economic policy inconsistent with the spirit of a free-enterprise system.

It is important, however, for the long run, that these short-run methods be supplemented by an effective policy for restraining excessive wage and price increases if current-account equilibrium is to be achieved at the existing rate of exchange. Monetary and fiscal measures can be used in the short run while wages and prices move differentially by comparison with foreign wages and prices so as to bring international costs into alignment. It cannot be emphasized too strongly that full employment and balance-of-payments equilibrium will at times be incompatible at fixed exchange rates unless there is some method of providing for price and cost adjustments.

THE CHOICE OF RESERVE ASSETS

Under a pure gold standard, central banks hold only gold as international reserves. Under the gold standard as it developed in the 1920s, and as it exists today, countries hold both gold and foreign exchange. The choice between gold and foreign exchange, and between different types of reserve assets, depends on the yield they offer and the relative safety of the assets. But tradition and banking law also play an important role.

When countries or individuals lose faith in the convertibility of one reserve asset into another at a given price, they are inclined to change the composition of their reserves. For example, when, after the 1934 increase in the price of gold in the United States, hot money flowed to the United States, there was speculation that the U.S. authorities might lower the price of gold, and many countries and individuals shifted from gold assets to dollars. Again, with the uncertainty surrounding the 1960 U.S. presidential elections, there were large-scale conversions of dollars into gold.

In the late 1920s, there were mass conversions of foreign exchange into gold. Thus, France in 1928 held \$2.5 billion in reserves,¹ of which one-half was in foreign exchange; by 1932, however, out of a larger total of \$3.4 billion, only five percent was in foreign exchange. Similarly, Germany reduced the proportion of foreign exchange in its reserves from sixty-three percent in 1924 to nil in 1931; Italy from sixty-two percent in

¹ See R. Nurkse, *International Currency Experience*, League of Nations, 1944, p. 35.

1927 to eighteen percent in 1932; and so on for most European countries. Part of these changes in tastes can be accounted for by lack of confidence in the reserve currencies, part by a belief in the political leverage of gold (including its strategic value as a war chest), and part by an "over-compensation" for the sins of past inflationary policies.

Over the past few years the EEC members have been raising the proportion of gold holdings in total reserve assets for reasons similar to those prevailing in the 1920s, although this time there are political overtones based on the idea that it is necessary to "discipline" the United States and United Kingdom for their "inflationary policies".

B. International Problems

WORLD LIQUIDITY AND THE BALANCE OF PAYMENTS

To connect the reserve holdings of individual countries with the world liquidity problem, we must start with the meaning of the balance of payments. The balance of payments of an individual country can be looked at as the sum of the current-account balance and the capital-account balance. When a country's net capital outflow is greater than its current-account surplus, it has a balance-of-payments deficit, which it must finance by selling reserves; and when its net capital inflow exceeds its current-account deficit, it has a balance-of-payments surplus, which it accommodates by buying international reserves.

If world reserves are constant, the sum of the balances of payments of all individual countries is zero,¹ so that if all countries want to accumulate reserves by running balance-of-payments surpluses, some countries' aims are necessarily frustrated; the surplus of any one country must be offset by the deficits of other countries. A good example of what may happen occurred in the 1930s when Austria tried to get reserves at the expense of Germany, Germany at the expense of England, England at the expense of America (after abandonment of gold), and America at the expense of the gold bloc after 1934.

Similarly, if all countries try to lose reserves, they must fail if world reserves are constant, because the attempt to realize a collective deficit for the world as a whole is then impossible.

A collective world surplus or deficit is not impossible, of course, if world reserves are changing. When world reserves are rising the sum of all measured balance-of-payments surpluses exceeds the sum of all

¹ Many countries, including the United States, define their balances of payments so capriciously that the sum of all balances is not zero even when reserves are constant. But we cannot go into the various asymmetries and inconsistencies here.

deficits, and when world reserves are falling the sum of all measured deficits exceeds the sum of all surpluses.

How can the sum of all measured surpluses exceed the sum of all measured deficits (or vice versa) when, in a more fundamental sense, the world as a whole always has a balance of payments equal to zero? Simply because reserve creation (whether by a gold-producing country, a reserve centre or the IMF) is separated from other transactions in national balance-of-payments accounts. In this respect, the world as a whole *including the source of reserve creation* will have a surplus or deficit depending on whether world reserves are increasing or decreasing. In the more fundamental sense (in which the world as a whole always has a balance of payments equal to zero), the world as a whole *excluding the source of reserve creation* will have a surplus or deficit depending on whether the source of reserves is creating or destroying reserves.

A liquidity shortage arises when countries want more liquidity than is being created, and a liquidity surplus arises when countries want less liquidity than is being created. When all countries want liquidity that they cannot collectively get, and there is a liquidity shortage, all countries *act like deficit countries* and a world contraction of trade and employment, or general competitive depreciation, begins. The contraction does not help the liquidity situation (except insofar as it reduces the desire for liquidity), and individual restrictive measures may be intensified, but to no avail. A liquidity shortage can be beneficial only if the world is in such a state of inflation that it is desirable to force countries to introduce restrictive monetary or fiscal policies.

When all countries have liquidity they do not want, and there is a liquidity surplus, all countries *act like surplus countries* and try to expand trade and employment. This is beneficial if there is general depression throughout the world, but harmful if the world is already fully employed. If the world is in a state of depression, an excess of liquidity promotes world expansion; if it is already fully employed, it merely causes inflation. Since surpluses promote more expansive policies with respect to trade and effective demand, while deficits promote more restrictive policies, increases in liquidity are beneficial or harmful depending on whether more expansive, or more restrictive, policies are needed in the world as a whole. Although actual changes in world reserves do not necessarily measure the changes in the desire of nations to hold them, it is more likely that reserves will exceed wants when reserves are increasing than when they are declining.

Only rarely, however, is the world in such a state of balance that all countries want to accumulate reserves at the same rate. Normally, some countries will be in deficit while others are in surplus. But the

same principles as previously cited continue to hold, though they may appear to have different implications. A normally distributed increase in liquidity makes surplus countries act *more* like surplus countries by increasing their discomfort with respect to a continued balance-of-payments surplus, stimulating more expansive policies; whereas it makes deficit countries act *less* like deficit countries by decreasing the discomfort they experience as a result of a continuation of their deficit. The *ability* of a deficit country to sustain a continued deficit is increased, while the *willingness* of a surplus country to continue its surplus is decreased. Both deficit and surplus countries may also recognize that the other group can be encouraged to adapt more rapidly or less rapidly, and hence they may delay or accelerate their own adjustment on that account. For example, why should the United States contract if it believes Europe will expand; or why should Europe expand if it believes the United States will contract?

It will be argued below that this implies that the adequacy of liquidity can be measured by the division of the adjustment burden between deficit and surplus countries. Other things being equal, an "equitable" sharing of the burden of adjustment would indicate that liquidity is just about right; a situation in which an excess of the burden fell on deficit countries would indicate a dearth of liquidity, and an excess of the burden on surplus countries would indicate a surplus of liquidity.

THE DISTRIBUTION OF THE BURDEN OF ADJUSTMENT

How can one determine what is the proper or equitable division of the burden of international adjustment?

If there exists a relative price disparity between deficit and surplus countries of, say, ten percent, and the price disparity must be eliminated by changes in relative price levels rather than through exchange-rate adjustments, should the deficit country try to lower prices by ten percent, the surplus country try to raise prices by ten percent, or should adjustment be divided between the two countries?

One consideration of importance will be the state of internal demand in the surplus and deficit countries. If there is inflationary pressure in the deficit country, it is clear that the deficit country should contract to prevent inflation; or if there is unemployment in the surplus country, it is obvious that the surplus country should expand; and if there is both unemployment in the surplus country and inflation in the deficit country, the surplus country should expand and the deficit country contract simultaneously. The solutions in these cases are obvious because the monetary action necessary to bring about international adjustment is consistent

with the monetary actions required for the restoration of internal balance (full employment and a stable price level) in the two countries.

The actions needed in these cases may not, however, suffice to bring about internal balance and international equilibrium at the same time. The expansion necessary to achieve full employment in a surplus country may be insufficient to restore external balance even when combined with the actions needed to stop inflation in the deficit country.

If the monetary policies needed to bring about internal balances are insufficient to restore international equilibrium, should the surplus country continue expanding, in the interests of international balance, at the expense of inflation at home, while the deficit country continues contracting and forsakes its internal goal of full employment? Should the distribution of the burden of adjustment be divided so that the deficit country suffers some unemployment and the surplus country some inflation? To what extent should Europe have inflated over the past five years to reduce her surplus relative to the appropriate degree of monetary discipline and stagnation in the United States?

At this point economists are inclined to say that it depends on the relative cost of inflation in the surplus countries compared to the cost of excess unemployment in the deficit countries. If, for example, the cost of unemployment were greater than the cost of inflation, maximum income would be preserved by the burden of adjustment falling mainly on the surplus countries, and if inflation were more costly, the reverse would be true. What is the cost of, say, a three-percent-a-year inflation in Europe as compared to an excess of unemployment of one or two or three percent of the labour force in the United States?

Rough estimates by the Council of Economic Advisers in the United States indicate that an extra one percent unemployment over four percent of the labour force costs the U.S. economy about \$15 billion. By this measure (which, for technical reasons, probably overstates the cost) the U.S. excess unemployment since 1958 has cost over \$150 billion, much more than the entire U.S. foreign aid program since the end of the war. There are, unfortunately, no comparable measures of the cost of inflation, but the psychological effects of rapidly and continually rising prices are exceptionally important in countries such as France, Germany, and Italy, which have had notoriously unfortunate experiences with inflation.

Fortunately, there is a simpler criterion that can be applied to supplement the argument raised earlier about internal stability. The distribution of adjustment under fixed exchange rates should be more or less in proportion to the relative size of the countries involved.

Consider again the situation in which there is a price disparity of ten percent between a deficit country (or group of deficit countries) and

a surplus country (or group of surplus countries) in the sense that a relative price change of ten percent is required to restore equilibrium; moreover, assume that exchange-rate changes are, wisely or otherwise, ruled out. If both countries are in a state of internal balance, international adjustment must imply inflation in the surplus country or deflation or unemployment in the deficit country.

Suppose now that the deficit country is very large relative to the surplus country. If total reserves of the two are constant, the deficit of the large country in absolute terms nevertheless equals the surplus of the small country. The deficit of the large country will be a relatively small proportion of its income and money supply, whereas the surplus of the small country will be a high proportion of its income and money supply. Ordinarily, therefore, the changes in the money supply that would be prompted by the disequilibrium (in the absence of neutralization policies) would represent only a small percentage change in the deficit country but a large percentage change in the surplus country. Under an automatic system, such as a common currency or gold standard, there would be no question but that the adjustment would fall heavily upon the small country and only lightly on the big country. For example, if Lombardy had a surplus with respect to the rest of EEC, prices and incomes would have to rise in Lombardy, rather than having to fall in the rest of the Common Market.

More precisely, under ideal conditions prices in a very small surplus country would rise by practically ten percent and prices in a very large deficit country would fall hardly at all. In the opposite case, in which the deficit country was small and the surplus country large, the bulk of adjustment would fall on the deficit country, with prices and/or employment falling in the deficit country and prices rising hardly at all in the surplus country. In formal terms, the adjustment would fall on the two countries in a proportion more or less corresponding inversely to the stocks of money in the two countries.¹

Adjustment *will*, typically, fall upon the small country, but it can also be argued that it *should* fall on the small country. If the object is to maintain price stability in the world as a whole, only small changes in the prices of the goods produced by a large country are needed (given a properly weighted price index) to offset large changes in the prices of goods produced by a small country. If all adjustment were to fall upon

¹ This change in relative prices would not necessarily involve a change in the terms of trade. Small countries generally cannot alter their terms of trade (without altering their exchange rates), and the adjustment is typically effected by a change in the price of domestic goods in the small country relative to the price of international goods.

a very large deficit country, the world would experience a general deflation or drastic unemployment; whereas if all adjustment were to fall upon a large surplus country, world prices would rise by the full amount of the required change in relative prices. Small countries *should* adjust to large countries and, under a smoothly functioning international system, *will* adjust that way. But special circumstances relating to confidence can interfere with this normal and efficient division of the burden of adjustment.

CONFIDENCE AND THE CONVERTIBILITY OF RESERVE ASSETS

The confidence problem concerns the exchangeability of one reserve asset for another at a fixed price. It can only arise if (1) there is more than one international reserve asset, and (2) there is no adequate mechanism for ensuring convertibility at a fixed price.

Let us assume that there are two international reserve assets, gold and a reserve currency, and that the reserve currency country buys and sells gold freely at a fixed price. Then if confidence in the convertibility of the currency into gold, and of gold into the currency, were maintained, countries would be indifferent between holding gold or the reserve currency — unless there are extra incentives for holding currency or gold. For example, if currency deposits yielded a rate of interest, or gold bore a storage cost, currency deposits would be preferred even under complete certainty.

Confidence is not, however, a matter of complete certainty, so that when international reserves comprise both a reserve currency and gold, individual countries typically diversify their assets, holding both. Thus it was that, during the gold standard period, countries that were not on a strict gold standard typically held both currency reserves (especially sterling) and gold. Similarly, in the postwar period countries have held dollars, sterling and gold, while some sterling area countries hold both sterling and dollars.

Whenever the exchange ratio between gold and a reserve currency is not believed to be permanent, speculation — both private and public — goes in one direction or another. When there is a substantial probability of a fall in the gold price, countries shift more of their balances toward currencies, as during the period following the increased U.S. gold price in 1934. And when the probability of a rise in the gold price in terms of the reserve currency is believed to be high, the demand for gold by private and public institutions goes up. These speculative demands are self-reinforcing, since sufficient gold sales during a time of pessimism about the gold price (optimism about the currency price) may embarrass the reserve currency country sufficiently to force the price change; and

similarly, sufficient speculation about a rise in the gold price, with consequent gold purchases, may sufficiently embarrass the reserve country (by drawing down gold stocks) to bring about revalorization.

To maintain a constant exchange ratio between gold and a reserve currency, the authorities in the reserve centre must have adequate stocks of both assets to ward off speculative attacks. In other words, they must have excess reserves large enough to overcome any concerted attack by private and foreign public speculators.

It is important to emphasize, however, a basic asymmetry between an attack on gold and an attack on a reserve currency. When gold is attacked, i.e., when there are sales of gold to the reserve centre, in anticipation of a fall in its price, in exchange for the reserve currency, there is no doubt about the *ability* of the reserve centre to supply its own currency in exchange for gold, although there may well be some doubt about its *willingness* to do so. No one doubted after 1935 that the United States *could* buy all the gold offered to it at \$35 an ounce in exchange for the U.S. dollar, although some doubted its willingness to do so. Again, no one doubted the *ability* of the United Kingdom to hold the sterling rate down to \$3.50 in March 1932, but there was widespread speculation about British *willingness* to do so.

When the attack is on the reserve currency, however, the reserve centre may not be *able* to withstand the attack, for it can never hold unlimited supplies of gold; and such an attack occurs only at times when gold supplies seem to be insufficient. If it is supplemented by speculation or defensive measures on the part of foreign central banks, there is obviously even less chance of success on the part of the reserve centre.

CHAPTER 3

■ The Weaknesses of the Gold Standard And the Present System

The preceding discussion provides a theoretical framework within which the effectiveness of various systems can be evaluated. How did the gold standard solve the liquidity, adjustment and confidence problems? How was the IMF supposed to function? To what extent has the IMF system failed?

A. The Gold Standard in Theory and Practice

In textbook discussions it is traditional to emphasize gold as an objective, impersonal medium of international exchange, settling balances between a number of autonomous financial centres. With gold as the single final arbiter of international finance, and the assurance of convertibility of the major currencies into gold, there was no confidence problem. The adjustment problem too was supposed to have been quickly solved by the interaction of gold flows on money supplies — and hence on interest rates and relative price levels — capital flows in the short run cushioning the impact of a disequilibrium while the long-run forces of deflation in deficit countries and inflation in surplus countries were working out a new equilibrium. There was also a mechanism for ensuring a proper amount of liquidity, with an excess of liquidity (too much gold) causing inflation of commodity prices and therefore an increased demand for gold, while in the long run higher costs of gold mining were limiting the production of gold; the opposite mechanism applied in the case of a shortage of liquidity (too little gold).

It is now believed, however, that the textbook model did not aptly describe the gold standard in practice. In the first place, the significance of the pre-eminent financial position of London in world capital markets has come to be better understood. London dominated the financial scene in the nineteenth century even more completely than New York dominates it today. It was sterling that gave gold its importance rather than the other way around, and it was the London capital market rather than gold settlements that provided the finance for balance-of-payments disequilibrium between third countries. As one observer¹ put it:

. . . Fixed exchange rates in terms of gold did not, however, give gold flows the equilibrating functions commonly ascribed to

¹ Hans O. Schmitt, "Political Conditions for International Currency Reform", Reprint No. 81, Social Systems Research Institute, Madison, 1964.

them. Instead, because exchange rates were stable in terms of each other, national money markets came to be linked by an effective system of international short- and long-term credit, centered primarily in London. These links permitted changes in the volume and direction of credit flows, rather than flows of gold, to keep international accounts in balance . . . British financial dominance was essential for the adjustment mechanism that operated in the nineteenth century. Disturbances in the international accounts were strongly . . . correlated with the business cycle in Britain. But an upswing in Britain would typically result in a gold inflow to augment the domestic currency circulation rather than an outflow to finance a current account deficit. This was possible because Britain, unlike any other country, could by its discount policy exert an immediate and powerful impact on the international flow of capital.

The nineteenth century gold standard, therefore, was developed and presided over by London financiers, and it became an effective instrument of British financial penetration into the rest of the world. It would be a mistake, however, to conclude that it was an efficient system for settling international payments.

The liquidity mechanism of the gold standard operated through the very measures which, according to modern ideas, rational control over the amount of liquidity is supposed to obviate. Gold production was sometimes subject to violent fluctuations as a result of new techniques and chance discoveries, and this meant that the world as a whole was subject to disturbing inflations and deflations which had no connection with the needs of trade or finance. To be sure, financial innovations, especially the growth of joint-stock banking, offset some of the eccentricities of gold. Also, deflation of commodity prices and costs in terms of gold diminished the amount of gold actually needed for trade and finance and simultaneously encouraged explorations for the relatively higher-valued gold, while inflation of commodity prices increased the need for gold and yet discouraged exploration; but these forces operated (to the extent that they were important at all) only after the damage of inflation or deflation had been suffered. The modern aim of controlling liquidity is to avoid inflation and deflation; under the gold standard, inflation and deflation were the means by which liquidity was controlled — from a twentieth-century vantage point, means and ends were confused. While it is possible that British financial domination mitigated somewhat the impact of sudden temporary changes in gold supplies and reduced the need for inter-country gold flows, it is clear that London could not and did not prevent the inflation resulting from the Californian gold dis-

coveries, or the world deflation of the last two decades of the nineteenth century.

Nor was the adjustment mechanism an efficient one. Britain transmitted its business cycle, through the mechanism of changes in the discount rate and credit supply, to the rest of the world. The discipline of deflation was generally accompanied by unemployment and general depression. As wage and price rigidities mounted with growing unionization and increasingly oligopolistic market structures, "deflation" increasingly took the form of unemployment. With the more popular base on which governments were elected, and new goals of economic policy, already pervasive after the turn of the century, governments increasingly adopted measures to avoid deflation and inflation and escape the "rules of the game". It has been said, with much truth, that trade unions made the gold standard inefficient, while universal suffrage made it unpalatable.

B. The Gold Exchange Standard and the IMF

With the abortive restoration of gold in the twenties, and its breakdown in the thirties, there was little support for a return to a gold standard system at the conferences held in 1944 at Bretton Woods. Instead, the new duty of sovereign governments to maintain internal balance — full employment and price stability — was recognized in the IMF Articles of Agreement. The IMF was conceived with the hope that the advantages of the gold standard could be retained while its defects were removed. As portrayed in one cartoon, its objective was not to abandon the gold standard but to humanize it!

It has been argued, with some truth, that the architects of the IMF agreement blamed the gold standard for the defects of another system, the gold exchange standard. At the Genoa monetary conference of 1922, a financial committee had recommended a new convention for economizing on the use of gold by holding reserves in the form of foreign exchange balances. The system was implemented in the twenties throughout Europe and large holdings of dollars and sterling were built up. The decline of these balances in the later twenties created the precarious reserve positions of the key currency countries that led to collapse in the 1930s. Thus, the failure of the international monetary system in the 1920s was not, so it is argued, the failure of the gold standard, but the failure of what had become its transmutation, the gold *exchange* standard.

It is important to recognize both the truth and the bias in this argument because it has been repeated recently. The truth in the argument is the possibility that the gold standard system could have been made to function tolerably well in the 1920s had the price of gold been raised to keep pace with the commodity price inflation of the war years. Even

without general revalorization of gold, it might have been possible, though it would have been difficult, to restore a gold bullion standard if Britain had not gone back to the prewar price of gold and created a relative price imbalance between the dollar and sterling. The mechanism might have brought about a reasonable degree of external balance, but it would probably have sacrificed high levels of employment or stable domestic price levels. Keynes in his *Tract on Monetary Reform* demonstrated the incompatibility of stable price levels and stable exchange rates in a dynamic and unevenly growing world economy.

The bias in the argument stems from a neglect of the factors which brought about collapse. It is simply wrong to argue, as Professor Rueff does, for example, that the gold exchange standard is doomed to collapse because it is built upon a pyramid of credit. What doomed the gold exchange standard in the twenties was not the holding, *per se*, of foreign exchange balances by central banks, but rather their sudden and unforeseen conversions into gold. After European banks had agreed to operate the gold exchange standard at the Geneva conference, they one after the other, led by France, withdrew their support for the system they had adopted. It was not the gold exchange standard itself, therefore, which was to blame for collapse of the international system in the 1930s, but the fact that the central banks, after committing themselves to the system, deliberately brought it down.

In any case, the IMF system was a compromise between abandoning gold and restoring the gold standard. The unit of account became the 1944 U.S. gold dollar, upon which par values (official exchange rates) for all currencies were to be based. Each country was to specify its par value to the Fund, but retain the right to alter this par value, after notifying the Fund, by a total of ten cumulative percentage points (five percent up and five percent down would exhaust the privilege) to take account of error in the initial statement of rates in the turmoil of immediate postwar conditions. After this right was used up, the Fund would have to give its consent to any change in the exchange rate, and it was required to give its consent whenever it believed there to be a "fundamental disequilibrium", an undefined term which experience was expected to elucidate.

It was hoped that these provisions would offer many of the useful adjustment features of the gold standard without its corresponding limitations. A country would not be forced to adjust to disequilibrium by inflation-deflation methods; it would have the alternative, if it could satisfy the Fund that its balance of payments was in fundamental disequilibrium, of changing the exchange rate. On the other hand, no country would be able to gain an unwarranted competitive advantage at the expense of its neighbours or attempt to export unemployment by

devaluation, because the interests of other countries would be safeguarded by the Fund's veto over unjustified devaluation. The adjustable peg mechanism, as the IMF exchange-rate system came to be called, would, nevertheless, retain the advantages to expanding trade of fixed exchange rates during normal times of basic equilibrium.

It was recognized, of course, that provisions would have to be made for cushioning or financing balance-of-payments deficits, especially those believed to be reversible. Hence the liquidity features of the IMF Articles of Agreement. Each country was given what was called a quota, the size of which was determined by a compromise between prospective needs and relative financial power; voting rights were in proportion to the quota. Subscriptions equal to the quota were paid one-quarter in gold and three-quarters in currency; and in time of need a country could draw upon the Fund by providing more of its own currency up to its whole quota in exchange for other currencies. A waiver privilege allowed drawings in excess of the national quota. Quotas were to be reviewed every five years, were in fact increased by fifty percent in 1958, and are about to be increased again, this time by twenty-five percent.

The Fund Articles also made a provision for "confidence" should a future scarcity of gold endanger the composition of world reserves. Members of the Fund could agree by majority vote on a change in the par values of all currencies; this would amount to an increase in the price of gold with no relative changes in exchange rates. Such action can, however, be prevented by any country which possesses ten percent or more of the total of the quotas — in effect, the United States or the United Kingdom.

From these provisions it should be evident that the authors of the IMF Articles of Agreement gave due account to the problems of adjustment, liquidity and confidence. The IMF constitution was a brilliantly conceived document designed to establish monetary order based upon international cooperation and orderly voting arrangements, while providing sufficient flexibility of international credit and exchange rates to allow for reasonable fulfillment of the new goals of domestic price stability and full employment.

C. Weaknesses of the IMF System

Why, then, has the IMF played such a relatively unimportant role in the current discussions of international liquidity? Given the mechanisms so carefully worked out for liquidity, adjustment and confidence, why have these mechanisms not been used effectively to resolve present problems?

The simplest answer is that countries have not wanted to avail themselves of the mechanisms contained in the Articles, partly for political reasons, partly because of a general belief that these mechanisms would not work, and partly because the Fund cannot itself initiate or compel changes in exchange rates. In the early postwar years, of course, the Fund was inactive because recipients of Marshall Plan aid were not supposed to supplement these resources by IMF drawings.

Consider the adjustment features of the Fund. When a "fundamental disequilibrium" in the balance of payments arises, the Fund is required to agree to exchange-rate adjustment. This is sensible enough, but the initiative rests entirely with the proposing member. The Fund cannot compel exchange-rate adjustment. True, if the country in major disequilibrium is a deficit country, the Fund can refuse access to its resources, so the country in deficit would eventually be forced to adjust somehow. But the Fund itself has no power over surplus countries. It cannot initiate measures for appreciation of a surplus currency. When, for example, Germany was in fundamental disequilibrium, possessing a large and growing surplus after 1956, the appropriate solution, which would have coincided with the German requirement of internal balance, was appreciation. Germany did not do this but instead continued to attract reserves from the rest of the world. To be sure, the threat of the Fund's "scarce currency" clause, by means of which a member's goods could be discriminated against, did prompt greater internal expansion in 1957; and Germany did appreciate by five percent in 1961. The former threat, however, was not initiated by the Fund itself, while the modest exchange-rate adjustment took place long after severe discomfort had begun to be experienced by other currencies (notably the pound sterling, but also the dollar). A similar argument holds with respect to France and other EEC countries in recent years.

The reluctance to alter exchange rates under the adjustable peg mechanism stems from at least two sources. The principle contained a basic flaw; the short-run rigidity allowed disequilibrating forces to be built up so that it was obvious in which direction an exchange rate, if it were to be altered at all, would be moved. Thus it cost practically nothing to sell sterling and buy mark assets in 1957, since it was obvious that sterling would not be *appreciated* or the mark *depreciated*, whereas it was entirely possible (even though the possibility did not materialize) that either the mark would be appreciated or sterling would be devalued (or both); moreover, this occurred at a time when long-term financial assets yielded a return in Germany at least equal to that in the United Kingdom. Similarly, this one-way option occurred (to the advantage of the speculator) in 1961 with respect to marks, in 1962 against the lire, and in 1964 against sterling. Recognizing this defect of the adjustable peg system,

countries have increasingly committed themselves to exchange-rate rigidity, resisting to the bitter end exchange-rate adjustments of any kind.

A special difficulty arises in connection with the capital values of assets in the reserve centres. Devaluation of sterling with respect to the dollar implies capital losses for sterling holders and would prejudice the future status of sterling as a reserve currency. Similarly, devaluation of the dollar (an increase in the dollar price of gold) implies penalties for those countries which have held dollars relative to those which have held gold. It is true that those countries which have held dollars rather than gold have earned interest on dollar holdings, and this provides at least a partial offset to capital losses. But countries can have their cake and eat it too if they can predict the timing of devaluation.

It has often been suggested that reserve countries are obligated to compensate for any losses on capital values sustained by other countries which have held a reserve currency that has depreciated. It is sometimes believed, for example, that the United States, is "morally committed" to compensate for any losses on dollar holdings countries would suffer in the event of a rise in the price of gold because they have held dollars rather than gold solely to avoid embarrassing the United States Treasury. (This does not apply to some holdings, such as "Roosa bonds", which are already denominated in the lender's currency.) The exact extent of U.S. informal commitments in this respect is not public knowledge, but historical experience suggests that countries should not rely on informal commitments in this regard. There may even be ambiguity as to whether a formal commitment has been offered.

The case of Dutch-owned sterling assets in 1931 is a case in point.¹ In August, before suspension of gold, the President of the Netherlands Bank requested a guarantee of compensation for a possible depreciation of sterling assets, but the request was apparently turned down. On August 29, 1931, however, the Dutch received a cable from the Deputy Governor of the Bank of England suggesting that the announcement of the new (and final) credits from New York and Paris "will serve to abolish all doubts as to the safety of foreign funds in London". The Dutch (incorrectly) took this to imply a moral guarantee of their sterling balances and demanded compensation after the decline of sterling; their demand was rejected, and this embittered relations between the two countries. In the paraphrase of one Dutch parliamentarian:

In matters of sterling, the fault of the Dutch
Is caring too little and trusting too much.

¹ The following example is based on P. Einzig, *The Comedy of the Pound*, London, 1933, pp. 44-46.

In any case, no central bank can afford to assume that there is any moral commitment for compensation unless a formal gold (or exchange) guarantee has been agreed upon; as Professor Rueff has said, “. . . if you have made a loan without a gold clause you are supposed to know what you are doing . . .”

There is still a third reason why exchange-rate changes in the larger countries have been resisted. Suppose, for example, that the mark is undervalued with respect to the dollar. Then appreciation of the mark could bring Germany back into balance, but it would doubtless also increase the surpluses of neighbouring EEC countries (as it did in 1961) and perhaps create the need for exchange-rate changes in those countries also. Or again, devaluation of the pound sterling would instigate exchange-rate changes throughout a large part of the world, affecting many other countries besides those in the sterling area. And finally, a devaluation of the dollar with respect to gold would have to be matched by devaluation in most of the world outside the EEC. There is, unfortunately, no effective centralized mechanism by which any of these exchange-rate changes can be accomplished under the adjustable-peg system in an orderly way. The financial stakes are so high that delay and ordinary consultations are impractical.

The adjustment of pegs has been, accordingly, abandoned, but the “system” has been retained in a way that does not rule out the *possibility* of changes in pegs. This preserves a speculative factor in the background that provides the disadvantages of both fixed and flexible exchange rates and the advantages of neither.

Because of the lack of a true adjustment mechanism, on the one hand, and the increasing volatility of hot money between financial centres, on the other, pressures on existing sources of finance expanded. But the Fund was inadequately equipped to handle the immense requirements of a reserve centre such as the United States, although until recently it has had sufficient resources to safeguard the pound. The problem was partly that the IMF provisions did not fully anticipate the resumption of the gold exchange standard, and partly that its own liquidity was impaired by its acceptance of the inconvertible currencies which left their issuers in a constant debtor position with the Fund. A substantial fraction of IMF currency holdings are now in inconvertible currencies which are useless as assets upon which other countries can draw.

The limitations of the Fund's liquidity position has led to supplementary arrangements. To supplement Fund liquidity, ten countries (the Paris Club)¹ arranged to commit \$6 billion (including \$2 billion supplied

¹ Belgium, Britain, Canada, France, Germany, Italy, Japan, Netherlands, Sweden and United States.

by the United States) in the event that the Fund needed to replenish its resources. Quotas are being increased again by twenty-five percent. The Bank for International Settlements has taken on a more active role as the representative of the central banks of Europe. And official discussions concerning the reform of the international monetary system are being centered on the OECD as well as the IMF.

D. The Precarious Position of the Reserve Currencies

The major reserve currencies, the pound and the dollar, have been weak for almost a decade. Their weakness, however, stems from somewhat different causes. The weakness of the pound derives from an adjustment problem faced by the United Kingdom, whereas the weakness of the dollar stems from the weakness of the system itself.

Britain holds reserves primarily in gold but, like other countries outside the outer sterling area, pegs the pound within limits of $\frac{3}{4}$ percent on either side of the par value of \$2.80. The United States, in contrast, pegs with respect to gold within margins of $\pm \frac{1}{4}$ percent of the fixed price of \$35 per ounce. The stabilization problem of a country in the sterling area is to maintain the convertibility of its currency into sterling; the problem of the United Kingdom is to maintain sterling convertible into dollars; and the problem of the United States is to maintain the dollar convertible into gold.

There are different types of currencies within the sterling area. Some countries (e.g., Malaysia), operating under a currency board system, keep their currencies rigidly fixed to the pound and govern their monetary policy automatically by the quantity of pounds held as reserves; for all practical purposes they are part of the U.K. financial system and maintain balance with respect to the United Kingdom itself. Other countries, e.g., Australia and New Zealand, allow their currencies to fluctuate within narrow limits in relation to the pound and exercise considerable discretion over the form of their reserves, which they may hold in sterling, dollars, and gold. Because a major part of the sterling area maintains balance-of-payments equilibrium with the United Kingdom, deficits in the United Kingdom typically arise now, not so much because of disturbances in the outer sterling area, but because of circumstances in Britain itself; deficits in the United Kingdom are closely connected with the activities of U.K. residents. Britain's difficulties have stemmed in large part from a failure to keep spending within the limits of income plus net borrowing, a failure induced primarily by the upward pressure of money wages accompanied by too slowly rising productivity.

The United States has been one of the few countries which has managed to achieve a reasonable degree of price stability in the past

several years. To a certain extent this is because the United States has acted like a deficit country whereas Continental Europe, as a unit, has acted like a surplus country. The monetary expansion in the United States has been very slow — too slow for full employment — while the rate of monetary expansion in Europe has been extremely rapid — too rapid for a proper maintenance of price stability. These changes have been induced in part by the balance-of-payments situation in Europe, which has a surplus, and in the United States, which, on the U.S. definition, is in deficit.

But the problem of measuring the deficit of a reserve country is not as simple as it seems. A simple (but invalid) measure of the deficit in the United States, closely approximating U.S. practice, is the gold loss plus the increase in dollar liabilities (which equals the increases in dollar assets of other countries) on both official and private account. However, as our preceding discussion on liquidity indicates, other countries typically will *want* to accumulate reserves every year because of economic growth, and portions of their surpluses will be *desired* surpluses. To the extent that this is so, U.S. treatment of increased dollar liabilities as a measure of its deficit would imply deflationary pressure on the world as a whole. If the United States were able to remove its “deficit”, other countries would not be able to accumulate those reserves they might actually want and need. Despite the fact that their balances of payments might register zero, they would have to undertake deflationary action (or exchange-rate changes or increased trade restrictions).

The proper measure of the deficit of a reserve country is not, therefore, the gold loss plus the increase in liabilities to foreign central banks, but the gold loss plus the excess of the *actual* increase in liabilities over the *desired* increase in liabilities (assets from the point of view of the other countries). To put it another way, the “deficit” of a reserve currency country can properly be measured only by the *undesired* surpluses of other countries. For example, if dollar liabilities increase by \$3 billion in one year, and foreign countries wanted to accumulate additional dollar reserves of \$2 billion, the U.S. deficit would be only \$1 billion.

To correct this deficit, the burden of adjustment under fixed exchange rates should be, as was previously argued, more or less divided in inverse proportion to the size of country. If, for example, the United States experienced an increase in liabilities of \$3 billion, the rest of the world outside Italy experienced a surplus of \$1.5 billion *which they wanted*, and Italy had a surplus of \$1.5 billion when it wanted only a surplus of \$0.5 billion, the “genuine” disequilibrium of \$1 billion between the United States and Italy should, in principle, be corrected more or less in inverse proportion to the U.S. and Italian money supplies, converted

at fixed exchange rates. Italy, being much smaller, would and should bear the bulk of the "burden of adjustment".

Now superimpose upon this situation the gold problem. Suppose that dollar liabilities increase steadily in comparison to the U.S. stock of gold, and that, as a consequence, speculation by private or official holders develops. The problem is then not one of adjustment, or liquidity, but of confidence, with perhaps a measure of politics thrown in. The speculation breeds upon itself, and the reserve position of the reserve country deteriorates. When central banks collude in the speculative attack, the power of the reserve country to act freely deteriorates.

A form of blackmail may even develop. Ordinarily, deficits under fixed exchange rates would be corrected roughly in proportion to the size of the country. But as the margin of freedom becomes progressively narrower, even small countries can, either by actual gold conversions, or the threat of gold conversions, force the reserve country to react to the confidence problem as if it were an adjustment problem. That is why the United States has believed itself forced to undertake adjustment measures which have been inefficient, costly, and largely futile, and which have not really benefited a single country in the western world, least of all the United States. And that is one of the reasons why many economists have supported the need for an overhaul of existing arrangements.

CHAPTER 4

■ The Gold Standard and Exchange Flexibility

Two of the most all-encompassing proposals for reform of the international monetary system have been the proposals to let exchange rates fluctuate or to return to the gold standard.

Poles apart in implication, the two proposals are close together in spirit insofar as they recognize the need to deal simultaneously with the liquidity, confidence, and adjustment problems and seek to end discretionary management. Let us first contrast the two proposals and then describe an intermediate system based on widening gold or exchange-rate margins.

A. The Gold Standard and Flexible Exchange Rates Compared

Under the proposal to return to the gold standard, liquidity would be provided by the old-fashioned mechanism, presumably after an initial increase in the price of gold; in the case of the flexible exchange rate system, the need for liquidity would be dispensed with (apart from minor needs which could be met by the existing IMF) because flexible rates are themselves a rapidly working re-equilibrating mechanism.

The argument for flexible exchange rates was revived in the 1950s by a number of distinguished economists, notably Professors Friedman, Meade, and Lutz, and it has since received widespread support among economists. The exchange rate is a price, so the argument runs, and should be allowed to fluctuate upward whenever demand for a currency exceeds supply, and downward whenever supply exceeds demand. Freed from the need to use monetary policy to protect the balance of payments, which the exchange rate would do automatically, the authorities could use monetary policy to pursue domestic targets (e.g., full employment) instead. The element of uncertainty that would arise could be hedged by expanded facilities of the forward exchange market, and the automatic appreciation or depreciation that would attend bullish or bearish speculation would immediately reduce it to negligible proportions by making it more expensive; well-informed, profitable speculation would be stabilizing. Countries could still hold international reserves and intervene in the exchange market in special circumstances, especially if these arose from political rather than economic factors; but in some variants of the argument, even limited intervention is regarded as undesirable or unnecessary.

The gold standard has been advocated by Professors Heilperin and Rueff, and the proposal has recently achieved greater prominence by the support of General de Gaulle. In Professor Heilperin's version of the argument (see *Fortune*, September 1962), a return to gold could be accomplished in two phases. The first would be an agreement among the nations of the Atlantic Community "to pay off all balance-of-payments deficits in gold and gold only" in order to "bring to a halt the perniciously deceptive spread of dollar holdings abroad under the gold exchange standard" and to give countries time to "get used to the new discipline". The second phase would be in three steps involving U.S. payment of its short-term dollar obligations, full convertibility of currencies into gold for domestic as well as international purposes, and a doubling of the price of gold in terms of all currencies.

The advantage claimed for the system is that it would start corrective forces, through changes in relative money supplies, as soon as an incipient deficit began, while the increase in the gold price would bring gold out of private hoards, make it more costly for use in the arts and industry and, therefore, make more new supplies available for monetary purposes, as well as encourage a sufficiently greater flow (eventually) from the mines. At the same time, governments would still be able to combat depression by budget deficits but would have to finance the deficits at market rates of interest. Heilperin concedes that difficulties would occur during the transitional period but believes the step toward international monetary order well worth the cost.

The two poles¹ from which advocates of flexible rates and the gold standard view the present system are interesting because they vigorously attack the heart of the international monetary problem — the lack of a speedy, effective adjustment mechanism — although they do it in opposite ways. A flexible system of exchange is a *nationalist* solution in the sense that countries are more independent in pursuing domestic goals and because a minimum of international cooperation is required, namely, the willingness of central banks to refrain from intervening in the free exchange markets at cross purposes. On the other hand, the gold standard is an *internationalist* solution requiring countries to abide by fixed rules of behaviour and central banks to engage in a great deal of interbank cooperation. In common, the two systems replace discretionary monetary management with a more or less well-defined set of rules, whether these are automatic, as under flexible rates, or artificially constructed, as under the gold standard. In the classical "rules versus authorities" dichotomy, most

¹ Parts of the following discussion have been adapted from my essay, "Problems of Economic Adjustment in the Atlantic Community", *American Review* (of The Johns Hopkins Bologna Centre of the School for Advanced International Studies), September 1962.

adherents of both flexible rates and the gold standard come out on the side of "rules".

A necessary condition for a pure gold standard system to operate today without creating excessive unemployment in deficit countries or inflation in surplus countries is some degree of adjustment in the rates of wage-rate expansion. Adjustment is made more palatable by economic growth. In a world of growth, cost discrepancies can be eliminated (roughly speaking) by changes in the relative rates of increase in wages or prices. Under the gold standard, wages in surplus countries tend to rise in excess of productivity increases, pushing up costs and prices and reducing competitiveness of products of surplus countries, while in deficit countries wages tend to rise by less than productivity, lowering costs and increasing the competitiveness of deficit countries. This encourages a faster expansion of exports in the deficit countries and a slower expansion of exports in the surplus countries. It is not required, as long as there is growth, that wages fall; it is sufficient that they expand more slowly relative to productivity than in surplus countries. In principle, it is not even necessary that wages in the deficit countries rise by less than productivity, provided that wages in the surplus countries are rising by sufficiently more than productivity, although if this is not happening, there will tend to be in the world at large a general increase in costs per unit of output, and prices will tend to rise unless inhibited by a general gold scarcity. But if wage restraint is practised in the deficit countries in relation to productivity growth, and wage expansion is allowed in the surplus countries in relation to productivity growth, it should be possible for international costs to be brought into harmony.

The degree of wage-rate flexibility that is required clearly depends upon the size of the "shocks" to which the international system is likely to be exposed; the greater the likely shocks, the greater must be the flexibility. Heilperin, like Rueff, argues that economists generally blamed the *gold standard* for the troubles in the interwar period, when they really ought to have blamed the *gold-exchange standard* or the particular parities to which Britain, and later France, returned. Yet if, as is generally assumed, the overvaluation of the pound in 1925 was of the order of ten percent, then it might be judged that an effectively working gold standard system would have been able to adjust to such a disequilibrium. We certainly cannot be confident that the magnitude of over- or under-valuation will always be less than ten percent. Yet the burden on Britain after 1925 as a result of this degree of overvaluation suggests that a modern gold standard system would require flexibility that was not present in the interwar period. To be sure, it can be argued that disequilibrium to the extent of ten percent will not arise because adjustment processes will be initiated immediately on the appearance of disequilibrium. But the

advocates of the pure gold standard have not been convincing about how adequate flexibility can be achieved without unemployment or inflation, nor have they offered persuasive arguments that the rate of production of new gold in the world can be made to conform, by a suitable adjustment in price, to that rate needed for a non-inflationary expansion of world trade and payments.

A flexible exchange system seems to impose fewer demands and is certainly capable of bearing greater shocks than a gold-standard system. A possible danger — often exaggerated — is that countries, freed from the need to protect their external reserves, would maintain insufficient internal discipline against price inflation; this assumes that countries would be less disturbed about exchange depreciation than about inflation, and that a central bank would react more strongly against a loss of exchange reserves. The system would admittedly not work at all well if wage rates were adjusted to the cost of living and the cost-of-living index were weighted heavily with import goods, for that might promote a persistent, automatic wage-price climb. The whole point of flexible exchange rates is the assumption that the community is willing to bear a reduction in its real income through exchange-rate changes but is not willing to accept the same real reduction through a change in money income. In any case, if full employment is to be achieved with price stability, then some means must be found of grappling with the problem of the wage-price spiral; and yet if a socially acceptable solution to this problem were discovered, there would then be little reason why an efficiently liquid gold standard (in a growing world) would not also work at a low level of unemployment, although even in that case flexible exchange rates could have the advantage of preserving stability of the prices of home-produced goods.

In the modern context the choice depends partly upon the firm rejection of the wage-price spiral (at least of widely disparate spirals in different countries) in the case of fixed exchange rates, and an accommodation to it in the case of flexible exchange rates. The threat to the level of reserves in the case of fixed exchange rates keeps pressure on the authorities to solve the wage-price problem, which they must do even if it means unemployment, whereas automatic depreciation can nullify some of the real effects of the wage-price spiral under flexible exchange rates. Under the gold standard, excessive wage or profit increases would cause underutilization of resources; under flexible exchange rates, such increases would show up in creeping inflation. The basic problem of relating income flows to productivity holds regardless of the system. When real adjustments are required, they cannot be escaped under any system whatsoever.

B. The Exchange Margins, Gold, and the IMF

We do not now have a system of fixed exchange rates. We have a system of exchange rates that are free to fluctuate within margins between exchange limits. The legal limits specified by the Fund are one percent on either side of par but in practice are set for the major European countries, as provided for in the European Monetary Agreement, at $\frac{3}{4}$ of one percent on either side of par. The Fund also permits, as a "multiple-currency practice", exchange-rate variations up to two percent on either side of par to allow for the "chains" of currencies attached within limits to other currencies which are in turn attached within the limits to the 1944 gold dollar, the IMF unit of account. The United States is a special case, and its position will be discussed later.

The margins are small, but their importance should not be discounted, for they have important effects on the conduct of monetary policy. Even if there is no speculation about an alteration of par values, there is speculation about exchange-rate changes between the exchange-rate limits, which can bring losses or profits to those engaged in the everyday business of trade and lending as well as to speculators.

Under the present system, *forward* exchange rates are perfectly free to fluctuate, although some countries do intervene also in the forward market. The existence of a forward market is one mechanism by which uncertainty about exchange rates, which many traders want to avoid, can be shifted to those able and willing to bear it — the speculators.

The present system is one of flexible spot exchange rates between the exchange-rate limits combined with more or less completely flexible *forward* rates except insofar as the authorities take *ad hoc* action to intervene in the forward market. The forward and spot exchange rates are, of course, related to one another through interest arbitrage, by which lenders can cover their exchange risk of lending in a foreign currency by buying domestic currency in the forward market.

U.S. POLICY AND THE LONDON GOLD MARKET

U.S. policy has made gold and the dollar close substitutes. The United States pegs the price of gold within the limits of $8\frac{3}{4}c$ ($\frac{1}{4}$ of one percent) on either side of the par value of \$35 an ounce, so that the Treasury buying price is \$34.9125 and selling price is \$35.0875. Transactions at these prices are available only to central banks for "legitimate monetary purposes".

There is a gold market in London open to all traders except U.K. residents, and this supplies the bulk of the private hoarding demand for

gold. But the range of variation in the London price is circumscribed by the U.S. Treasury price. The insured cost of shipping gold between New York and London is about 10c per ounce so that the range of the London gold price will not normally be greater than the range of the United States Treasury buying and selling price plus or minus the shipping costs. When the London gold price gets to \$35.0875 plus the cost of shipping, or almost \$35.20, it is profitable to ship gold from New York to London; and when the London gold price falls to about \$34.80, it is profitable to ship gold from London to New York¹. Of course, if central banks were indifferent between holding gold in London and holding it earmarked in New York, it would never be profitable for them to pay more for gold in London and the U.S. Treasury selling price or sell it for less in London than the U.S. buying price. In practice, however, central bank purchases and sales in the London market are restrained by institutional arrangements, especially that of the recently formed gold pool.

The Bank of England acts as the agent for gold producers (mainly South Africa) in the sterling area, for many central banks, and for the recently formed gold pool, with respect to activities in the London gold market. The Bank of England, either on its own account or on account of the gold pool, has generally fed gold into the London market to prevent its price from rising above about \$35.20 (except for the breakdown in 1960). Typically, however, the price is effectively kept from rising above \$35.12, both because foreign official institutions apparently refrain from buying it above \$35.08 and because the Bank of England has typically bought and sold gold on account of the gold pool between \$35.10 and \$35.15.

Even though the price of gold in the London market can, in principle, drop to \$34.9125 and even (in case they have geographical preferences) to \$34.80, the price of gold in London since the middle of 1958 has effectively ranged above \$35.06. Speculators feel they have a one-way option, since the United States has not been able to eliminate speculation that the U.S. Treasury might raise the price of gold in terms of the dollar, while it has given no basis for a belief that it might ever lower the price of gold in terms of the dollar. The one-way option, based on Treasury policy and on rumour, has greatly encouraged gold hoarding. Of annual production now in the range of \$1.5 billion, over half is typically taken up by the private market, most of it for speculative purposes, since the demand for use in industry and the arts is only of the order of \$250 million. According to the IMF, it has been estimated that in the postwar

¹ For a detailed account of U.S. policy with respect to gold see Robert Z. Aliber, *The Management of the Dollar in International Finance*, Princeton Studies in International Finance, No. 13, 1964.

period about \$15 billion of gold has been diverted, as a result of political and economic uncertainties, from official holdings to other uses. A large proportion of these hoards would be made available to official reserves if the market expectation of an increase in the gold price were reversed.

GOLD MARGINS AND THE ARTICLES OF AGREEMENT

The first step in altering expectation is to make it possible, and credible to the market, that the price of gold can go down as well as up. The simplest way to accomplish this objective is for the government to remove the floor implicit in its Treasury buying price. However, this involves many legal and practical complications.

To understand the legal complexities, it is necessary to have a clear picture of the IMF provisions with respect to exchange-rate stability and the relation of the gold price to exchange-rate stability. First it must be noted that the Articles of Agreement state clearly that one of the purposes of the International Monetary Fund is

to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

In the past twenty years there have been many departures from "orderly exchange arrangements" and "exchange stability". In the immediate postwar period some of the major countries violated the letter of the Articles, and France was refused access, for a short period, to the Fund's resources. There have been periods of considerable exchange-rate chaos, mainly among countries with inconvertible currencies; during transitional periods, in moving from one par value to another, the Fund has tolerated and even urged fluctuating exchange rates as a transitional device until the equilibrium value of the currency could be specified. Canada had a flexible exchange rate, which the Fund did not have the authority to approve, from 1950 to 1962. It is in the light of this history that "exchange stability" and "orderly exchange arrangements" are to be understood. Any change in existing arrangements that would threaten to cause greater exchange instability than has existed or is likely to exist under present arrangements would probably have to be considered contrary to the purposes and practice of the IMF.

Second, by Article IV, all currencies have par values expressed in gold or the U.S. gold dollar "of the weight and fineness in effect on July 1, 1944", and these par values are to be used for purposes of applying the Fund agreement. The next section relating to gold purchases is important:

Sec. 2. *Gold Purchases Based on Par Values.*

The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin.

In other words, the Fund (which means the Executive Board subject to review by the Board of Governors) can prescribe the margins for buying and selling gold. Curiously, the Fund sets the *lower* limit for *sales* and the *upper* limit for *purchases*. Thus, if the Fund set margins at $\frac{1}{4}$ of one percent, the United States could not *buy* gold at a price *above* \$35.0875 or *sell* it at a price *below* \$34.9175. *Literally*, the text means that the United States could sell gold at as high a price as it wants and buy it at as low a price as it wants. However, while the United States is permitted to sell it at prices above the upper limit (for purchases), no other member could buy it at such prices. For intercentral-bank purchases and sales, then, the United States is restricted within the limits set by the Fund.

These limits were initially (June 10, 1947) set by the Fund at one-quarter of one percent plus costs, but the rules were later amended (October 15, 1954) and extended (November 5, 1954) to read as follows:

For transactions in gold by a member the margin above and below par value shall be, at the option of the member, either:

1. One quarter of one percent plus the following charges:
 - a) The actual or computed cost of converting the gold transferred into good delivery bars at the normal centre for dealing in gold of either the buying member or the member whose currency is exchanged for the gold;
 - b) The actual or computed cost of transporting the gold transferred to the normal centre for dealing in gold of either the buying member or the member whose currency is exchanged for the gold;
 - c) Any charges made by the custodian of the gold transferred for effecting the transfer; or
2. One percent, which one percent shall be taken to include all of the charges set forth in 1 above.

The United States is therefore permitted to engage in transactions in gold with other members between the limits of \$34.65 and \$35.35, or one

percent of par value on either side, although it has thus far kept to the narrower margins of one-quarter of one percent.

The question now to be considered is whether the Fund is permitted to authorize gold margins wider than the one percent that it already permits. This question involves the relation of the gold margins to the exchange margins.

Section 3 of Article IV states that:

The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territory shall not differ from parity

- (i) in the case of spot exchange transactions, by more than one percent; and
- (ii) in the case of other exchange transactions, by a margin which exceeds the margin for spot exchange transactions by more than the Fund considers reasonable.

In other words, (spot) exchange transactions have to be kept within one percent of either side of the par value. It will be recalled that this limit was effectively widened to ± 2 percent to allow a country to peg onto a reserve currency which was in turn pegged onto another currency, under the theory that this could be justified as a "multiple-currency practice".

But does this mean that a country such as the United States has to peg the price of the currency of every other member country, inside its own (U.S.) territory, within ± 1 percent or ± 2 percent? The first sentence in Section 4(b) seems to imply this, for it states:

Each member undertakes, through appropriate measures consistent with this Agreement, to permit within its territories exchange transactions between its currency and the currencies of other members only within the limits prescribed under Section 3 of this article.

However, the strategic escape from this requirement is given in the crucial second sentence:

A member whose monetary authorities, for the settlement of international transactions, in fact freely buy and sell gold within the limits prescribed by the Fund under Section 2 of this article *shall be deemed to be fulfilling this undertaking.* (Emphasis added.)

In other words, countries that are buying and selling gold *within the limits prescribed by the Fund* are relieved of the responsibility of main-

taining exchange rates inside their territories within one percent (or, in certain cases, within two percent) of par values.

Only the United States has taken advantage of this provision. All other major members of the Fund with convertible currencies maintain exchange rates within the required one percent and, in fact, at $\frac{3}{4}$ of one percent. Given the system by which the United States pegs gold within $\frac{1}{4}$ of one percent, whereas other major currencies peg the dollar within $\frac{3}{4}$ of one percent of parity, the maximum price foreign countries can pay for gold bought from other members is one percent above the foreign currency equivalent of \$35 per ounce. For example, the par value of the Deutschemark is DM 4 = \$1, so that the par value of marks in terms of the par value of gold is DM 140 (i.e., 4×35) per ounce. Now the mark fluctuates with respect to the dollar within $\frac{3}{4}$ of one percent, so that the limits at which the Bundesbank can buy and sell dollars are, respectively, DM 3.97 and DM 4.03. Are these limits also within the permissible limits for selling and buying gold from the United States? If the dollar were at its upper limit with respect to marks (DM 4.03) and the price of gold were at its upper limit in terms of dollars (\$35.0875), the price of gold in New York in terms of marks would be DM 141.4 (i.e., 4.03×35.0875). This is within one percent of the par value of marks expressed in terms of the par value of gold (i.e., $141.4 = 1.01 \times 140$). In other words, the Bundesbank would still be permitted to buy gold from the United States even though gold were at a maximum value in terms of dollars, and dollars were at a maximum value in terms of marks. A similar relation holds with respect to German sales of gold when the dollar price of gold is low and dollars are at their minimum value in terms of marks.

The Fund, therefore, sets the gold margins, while the Articles of Agreement determine the exchange limits. A literal interpretation of the Articles, then, suggests that the Fund itself, without any amendment of the Articles of Agreement, can widen the gold margins above one percent on either side.

But might it not be argued that this violates the spirit, if not the letter, of the Fund Agreement? After all, one of the purposes of the IMF was to "promote exchange stability". Unrestricted freedom of the Fund to widen gold margins could result not merely in a fluctuating price for gold, which could be desirable in itself, but also considerable fluctuation in the exchanges.

This would not happen automatically under the present scheme if all countries, directly or indirectly, continued to peg to the dollar. But it would be possible because of the right of any country to abandon "dollar-pegging" for "gold-pegging". For example, suppose that the Fund

widens the gold margins to ± 5 percent so that the United States can buy gold at \$33.25 and sell it at \$36.75. In itself this would not mean any enhanced exchange flexibility because countries may continue pegging to the dollar. But suppose one country, say France, abandons its policy of pegging to the dollar within margins of $\frac{3}{4}$ of one percent and shifts to the enabling clause in Article IV-4-b, which permits any country to buy and sell gold within the widened gold margins, automatically relieving it of the responsibility for keeping exchange rates within one percent.

If the par value of the franc is taken in round numbers as $F5 = \$1$ (it is actually $F4.937 = \$1$) or $F175$ per ounce of gold, France would buy gold at $F166.25$ and sell it at $F183.75$. This would allow the franc-dollar exchange rate to fluctuate up to about twenty percent, i.e., between approximately $F4.5 = \$1$ and $F5.5 = \$1$. Would this be consistent with the spirit of the Fund agreement, which was intended to "promote exchange stability"?

It is here that the interpretation of exchange stability and the experience of the Fund thus far becomes crucial. If wider margins could be expected to reduce the risks of financial chaos or an acute liquidity shortage, they would truly promote exchange stability, in contrast to the instability that might otherwise have been the case. Exchange flexibility within gold margins — assuming that at least one country joined the United States in adhering to the gold-pegging clause — does not imply instability, but simply the escape valve needed to preserve exchange-rate order of a more fundamental sort.

It may be concluded, therefore, that the IMF Articles leave the Fund wide latitude with respect to widening the gold margins. The Fund could not widen them to an extreme degree (e.g., thirty percent), for that would be tantamount to virtually flexible exchange rates with no practical limits for countries agreeing to peg gold at the specified margins; and the founders of the IMF at Bretton Woods rejected a system of floating exchange rates. But they could widen the gold points to any degree that might reasonably be expected, in the long run, to "promote exchange stability". The Board itself is the arbiter of how large a widening of the gold points is consistent with the promotion of exchange stability; and as they have approached the interpretation of other clauses in the Articles, with respect to gold sales, capital movements, and exchange rates, in a liberal spirit of adaptability and flexibility, they might be inclined to treat the equally important issue of widened gold points in the same spirit.

CHAPTER 5

■ Optimum Currency Areas and Monetary Blocs

In a shorthand way, because of the exchange limits, the present system is often referred to as a fixed-exchange-rate system, while a system in which the exchange-rate limits are removed or widened so far as to become inoperative is referred to as a flexible-exchange-rate system. But the issue of fixed and flexible exchange rates can be posed in an alternative way, along the lines¹ of "optimum currency areas".

A. Optimum Currency Areas

A currency area is an area within which exchange rates *are* fixed. Obviously, then, Quebec and Ontario are parts of the same currency area, and so are Massachusetts and Texas, and Tuscany and Piedmont. If, further, we ignore the width of exchange-rate margins (a fair approximation for some purposes), Canada and the United States are parts of the same currency area, and so is the whole western world, insofar as each country keeps exchange rates pegged (except for the margins) between one another.

An *optimum* currency area is an area within which exchange rates *ought* to be fixed. If Canada *should*, according to some criterion, have a single currency, then Canada is an optimum currency area. So is any country that ought to have a single currency.

An interesting question, therefore, is the criterion for optimum currency areas. Is the optimum currency area the nation? Should all national currencies fluctuate? In an earlier analysis of the problem², the author argued that the appropriate currency area for purposes of stabilization policy is the region (the definition of which involves factor mobility), subject to the requirement that the fewer currency areas there are, the better, in terms of (1) gaining full benefits from the functions of money as a unit of account, medium of exchange, and store of value since different moneys always represent an inconvenience; (2) avoiding the possibility of monopolistic speculation since some private corporations holding local currencies may have greater resources than central banks;

¹ An alternative is to pose the issue as a question of optimal exchange-rate margins, a problem I have discussed in an essay, "The Exchange Margins and Economic Policy", in *Money in the International Order* (ed. J. C. Murphy), Dallas, 1964.

² "A Theory of Optimum Currency Areas", *American Economic Review*, September 1961.

and (3) maintaining the kind of currency illusion and rigidities of prices that must exist in order to make exchange-rate variations effective at all, since the effectiveness of exchange-rate variations requires that productive factors do not immediately demand compensating monetary rates of remuneration for any alteration in the real value of assets or real cost of purchasing commodities.

According to this generalization we should not seek to answer the question whether or not fixed exchange rates are better or worse than flexible exchange rates, but rather the question: how large are optimum currency areas; what domain do they encompass? This is directly linked to political questions which concern how large we want regions to be, how much factor mobility we want and will allow, and in what unit we want wages and prices to be expressed.

Broadly speaking, therefore, we cannot answer the question until some political values have been specified. But a few common-sense comments may avoid unnecessary confusion. As long as the basis of our political aspirations centres around the nation-state, countries will maintain a single currency within their own borders. The political implications of forming separate currencies within a country are overwhelming unless the country is already in a process of political disintegration, so that short-run economic factors are not likely to be overriding. In any case, the existence of a nation-state may presuppose that, if it is not a region, it may be made a region in the sense of having full and complete factor mobility. For this reason we can begin, as a practical political guide, with the assumption that the optimum currency area is not smaller than the nation.

But optimum currency areas may well be larger than the nation. The Netherlands may well want to keep the guilder pegged to the mark; Luxembourg will certainly maintain its currency at par with the Belgian franc; Ireland, perhaps, with the pound sterling; and so on. We can feel fairly safe about small countries tied very closely with larger neighbours.

The monetary authorities throughout the developed western world, however, have a preference for fixed exchange rates *per se*; and this predisposition suggests that the optimum currency area will be judged, at least in a subjective sense, to be considerably larger than the nation-state. The political and economic contacts between Britain and Scandinavia suggest fixed exchange rates in that part of Northern Europe as well as in other parts of the sterling area. And the growing closeness of political and economic relations forged within the Common Market, combined with growing migration, increased freedom of capital movements and the eventual reduction in tariff barriers, suggests that the EEC may well want the added integration that is an inevitable by-product of a com-

mon currency or, in a lesser way, fixed exchange rates. As the German government put it in rejecting a proposal of five experts that Germany let its exchange rate float:

Fixed exchange rates are an indispensable element in a world committed to integration; with a system of flexible rates the existing readiness to cooperate and integrate might be destroyed at the first appearance of serious difficulties since flexible rates would offer such an easy opportunity for isolated action.

Canada and the United States offer another case in point. Canada has had good and bad experiences with both a flexible rate and a fixed rate. With a serious drive toward economic integration of the two countries, the advantages of fixed exchange rates would increase in comparison to flexible exchange rates; and in the far-distant future a move toward a currency union (or its economic analogue, absolutely fixed spot and forward exchange rates) is not out of the question. Elsewhere I have suggested that, on the evidence of Canada's past experience, a properly run flexible exchange rate with respect to the United States is preferable at this stage of integration of the economies; but there is nothing to prevent, in the far-off future, a movement in the other direction, especially if it were judged desirable to take advantage of even greater capital mobility and migration. Should it become the aim of Canada and the United States to develop continental resources on an integrated basis, either a common currency or absolutely fixed exchange rates between the two countries could be an important contributory factor.

The significant lesson to be learned from this, however, is that whether countries choose to peg to the currency of another country (rigidly or within margins) will depend on their self-interest, which will form subjective conceptions of what currency areas are optimum. National decisions will continue to be overriding for a long time to come.

B. An Imaginary World of Three Monetary Blocs¹

The two major currency blocs are now, of course, the dollar area and the sterling area. It is possible, and indeed likely, however, that if integration among EEC members moves to the monetary level, a third bloc of major importance will develop, based on a new European currency asset. Let us imagine, therefore, a European dollar, the "thaler", composed of (about) 50 belgas, 35 guilders, 620 lire, 4 marks, or 5 francs. The result might be a monetary division of the free world into

¹ The reader is reminded that the authors of the Brookings study recommended, as an (inferior) alternative to a system of fixed exchange rates supplied with ample liquidity, a world of two monetary blocs separated by flexible exchange rates. See Salant and Associates, *The United States Balance of Payments in 1968*, Brookings, 1963, pp. 258-262.

the *sterling area* (much of the old British Commonwealth, Scandinavia, and the Middle East), the *thaler area* (composed of Continental Europe and some of Africa), and the *dollar area* (the United States, Japan, Canada, most of Latin America, and parts of the rest of the world). The blocs would be quite informal organizations reflecting the channels of international trade and finance, with London, Amsterdam (say), and New York operating as major deposit centres.

It is natural to suppose that the dollar would be used for settling international transactions within the dollar area, through shifts of balances in New York, much as sterling is now used in London, and as our hypothetical "thaler" might be at some distant date in Amsterdam or other central European markets. Individual countries within each area would still have to preserve general balance in their international accounts, but the problem of intra-area liquidity would be resolved by the monetary policy of the dominant financial centre.

A major problem, however, would arise in connection with the settlement of accounts *between* areas. It is unlikely that politically distinct blocs would be willing to hold large external reserves in the central currency of other blocs. If this were so, a mechanism for inter-area adjustment and a medium of interarea liquidity would have to be developed. These devices would probably have to be developed from those which currently exist.

One possibility would be to go onto the gold standard for the settlement of interbloc balances, and another would be to let the three dominant currencies—the dollar, pound and thaler—fluctuate with respect to one another. However, if the gold standard mechanism is ruled out for individual countries, it is far more likely to be ruled out between different blocs, each of which would be pursuing separate policies. The discipline would be evaded, and the result could be a mutually destructive form of trade restrictions between blocs imposed for balance-of-payments reasons. Complete flexibility of the exchange rates, on the other hand, would allow the blocs to pursue separate financial policies but would again be greatly resisted by the business and banking communities. Fortunately, there is an alternative that could simultaneously provide many of the benefits of flexible rates while retaining some of the virtues of the gold standard.

This alternative is for the prospective dominant centres to fix their currencies to gold, but at substantially widened gold margins. The purpose of pegging to gold at all would be to preserve gold as a useful (because acceptable) medium of international settlement. The purpose of pegging to gold with reasonably wide margins, on the other hand, would be to permit the major blocs to exploit the possibility of a moderate degree of exchange-rate fluctuation as a mechanism of international adjustment

without allowing the reserve countries to press inflation on the outer countries. Par values of the central currencies could be pegged in terms of gold, perhaps even at their present parities, but market values of the currencies would fluctuate in accordance with the forces of supply and demand for the currencies and gold within a predetermined range.

There are three major types of advantages arising from the use of gold for settling interbloc balances and of a widened gold margin on which the three major blocs would peg. The first advantage is that the exchange flexibility which this arrangement would permit would allow a wider scope for discounts and premiums on forward exchange. This possibility would permit a wider separation of interest-rate policies in each centre. Different interest rates would imply capital flows from the low interest centre to the high interest centre under a common currency or under different currencies rigidly pegged together; but with widened exchange margins a discount would develop on the forward currency in the high interest centre, increasing the expense of covering the exchange risk and slowing the speed at which the capital movement would be affected. In an integrated world, of course, these capital movements (which widened margins could decelerate) are desirable; that is why narrow exchange-rate margins should be retained within each bloc. But between blocs, huge capital transfers could be regarded as a source of disturbance and could induce counter-vailing responses on the part of the authorities in the forward exchange markets. Especially where the disparities between interest rates in the different blocs were high, wider margins would slow the rush of capital from one centre to another.

The second advantage of the system, provided the margins were made wide enough, would be that basic trade balances would have room in which to be corrected through the international price mechanism without exclusive reliance on movements of domestic price levels. Of course the centre countries would still have to take account of international costs; drastic failure to keep international costs in line would involve hitting one of the gold points and the consequent loss of gold reserves that support for the limits would entail. The discipline of the gold standard would have to be applied at the limits, yet there would still be considerable room for price adjustments within those limits.

A third advantage is that the centre countries would intervene in the exchange market only in terms of gold against their own currency. The British authorities, for example, would not be permitted, except perhaps in a transitional period, to exchange dollars for thalers or sterling for thalers or sterling for dollars, but only sterling for gold. Here the advantage of gold as an anonymous external unit could be exploited to keep foreign centres out of "each other's" exchange markets. After all, there is no reason why the United States should be able to

conduct open market operations in London, or the Europeans in New York, without the consent of the financial authorities of the affected centre.

In this imaginary world of the dollar bloc, sterling bloc, and thaler bloc, the dollar, pound, and thaler would be convertible into gold for the monetary authorities within the agreed-upon gold limits of a fixed percentage on either side of the par value. Would such a system serve the interests of the outer countries as well as the interests of the dominant centres? The answer is yes, for the outer countries, unlike the centre countries, would have the advantage of being able to hold liquid international reserves in interest-bearing assets. They would have the option of shifting from one reserve centre to another in the event that political or economic alliances changed. There would, in fact, be a form of friendly triopolistic competition for deposits among the three centres. That centre whose currency was most stable in terms of goods would have a considerable advantage over other centres. That country which was able to provide the best capital market services would again have an advantage. Competition would induce each centre to provide special services to its own customers. Centres which failed to provide adequate facilities would suffer a loss of deposits like any bank. Outer countries would also have far greater freedom than the main centres with respect to adjustment of their own balance of payments.

One final matter remains to be considered. There is the long-run possibility that gold might become scarce or redundant. One way to offset this would be for the main centres to raise or lower the price of gold in accordance with the IMF rules. But this would be an inappropriate, costly, and inexact method. It would be inappropriate because it is nearly always accompanied by rumour and speculation, with potential embarrassment to the monetary authorities of the major centres. It would be costly because, in the event of secular increases in the gold price, additional real resources would be devoted to gold mining. And it would be inexact because periodic price changes make the gold stock initially too large and ultimately too small.

To make price changes unnecessary, the IMF could eventually be turned into a deposit bank, accepting gold and issuing gold certificates in exchange. Initially the reserve ratio would be one hundred percent backing of gold behind gold certificates. The main centres would then keep their currencies convertible, within the specified margins, into gold certificates rather than gold itself, while the new IMF would be responsible for maintaining gold certificates convertible upon notice into gold. As the need arose, the reserve ratio of gold behind gold certificates could be decreased or increased, without running any of the risks of speculation in the private gold market, of the sort that has proved so embarrassing to the U.S. authorities at the present time.

CHAPTER 6

■ Summary and Conclusions

It is time to collect the threads of the analysis, to speculate about the future, and to project a timetable for international monetary reform. A summary of principles and observations is the simplest way to begin.

A. Principles and Observations

CONCEPT OF THE BALANCE OF PAYMENTS AND INTERNATIONAL RESERVES

(i) Definition of the balance of payments is inseparably connected to the definition of international reserves. A country's balance-of-payments surplus is its accumulation of officially held international reserves, while its deficit is its loss of reserves. Put another way, a country's deficit is *financed* by a loss of reserves, and a surplus is *disposed of* by the purchase of reserves. Once the assets comprising international reserves are specified, the meaning of the balance of payments is evident; and once the meaning of the balance of payments is set, the assets which comprise international reserves are clear.

(ii) A definition of the balance of payments as the increase in its international reserves presents no difficulties for a gold-producing country. The balance-of-payments surplus of a gold-producing country is the increase in the international reserves held by its monetary authorities. If gold were the only international reserve asset, then the increase in a gold-producing country's international reserves would be that part of gold production which is bought by the monetary authorities and not offset by their sales; gold production not used in domestic markets is treated as a commodity export.

(iii) Nor does the definition present any problem for a reserve centre (although there may be institutional reasons why special treatment may be adopted). If a national currency were also the international reserve asset used by other countries as international reserves, the balance-of-payments surplus of a reserve centre would be the difference between the change in assets and the change in liabilities of the central bank in the reserve centre, a difference which is, for all practical purposes, zero. The balance of payments of a reserve-centre country whose currency was the only international reserve would always be in equilibrium, while the sum of the balances of payments of other countries would be the additional deposits (which could be either positive or negative) held in

the money market of the reserve centre. A possible defect of a system in which a single national currency is also the sole international means of payment is that the issuing national central bank has no balance-of-payments constraint.

(iv) When the currency of a reserve centre is convertible into gold, however, the balance of payments of the reserve centre is best regarded as equal to the change in its gold holdings, for, whereas gold and foreign exchange are both looked upon as international reserves by other countries, gold is the only international reserve asset of the reserve centre. In this way the world balance-of-payments surplus is brought into accounting equality with the sum of the increase in foreign-exchange holdings and the increase in monetary gold.

LIQUIDITY AND THE BALANCE OF PAYMENTS

(v) Countries want larger international reserves as their economies get bigger, to provide additional safety in the event of greater imbalances in the future; they also want a wider range of choice with respect to the type, scope and timing of future corrective measures that may become necessary. To get additional reserves, a country has to generate a balance-of-payments surplus. But whether or not all countries can simultaneously develop balance-of-payments surpluses depends on whether or not international reserves are growing over time. Unless international reserves grow over time, one country can obtain reserves only at the expense of other countries.

(vi) A liquidity shortage exists when countries compete for an inadequate world stock of reserves. One country tries to get reserves by developing a surplus in its own balance of payments at the expense of smaller surpluses (or larger deficits) than other countries want in their balances of payments. A liquidity shortage is a fight for unattainably large balance-of-payments surpluses (or unattainably small deficits).

(vii) If there are inflationary pressures in the world as a whole, a liquidity shortage can have a stabilizing effect if countries adopt more restrictive monetary and fiscal policies in their attempt to generate additional surpluses. On the other hand, if there is unemployment throughout the world, a liquidity shortage can have disastrous consequences, inducing restrictions that exacerbate the depression and cause a collapse of trade and capital flows.

(viii) In a situation of world equilibrium in employment and prices, i.e., when there are no pervasive inflationary or depressive tendencies in the world as a whole, the stock of world reserves should neither exceed nor fall short of the willingness to hold them. It is still important to

provide for the *additional* reserves each country will typically want every year — that is, to provide for a regular *flow* of new reserves into the international monetary system — for otherwise a situation of world balance could quickly turn into a situation of depression as countries adopted self-defeating restrictive financial or trade measures in their efforts to get surpluses, and therefore reserves, at the expense of other countries.

CONFIDENCE AND THE COMPOSITION OF RESERVE HOLDINGS

(ix) If there were only one international reserve asset, such as gold or the dollar or sterling, there could be no confidence problem, although there might still be adjustment problems and liquidity problems. The confidence problem arises from the existence of more than one reserve asset and the lack of a mechanism for ensuring that one reserve asset is convertible into another.

(x) Gold and foreign exchange are not perfect substitutes in a country's reserves. A certain amount of the reserve currency must be held for exchange-market operations if a non-reserve centre (outer country) pegs its exchange rate to a reserve currency, and this makes the demand for a small amount of foreign-exchange reserves inelastic for most central banks, similar to the demands for transactions balances on the part of the private community.

(xi) The demand for asset balances (the idle part of a country's exchange reserves), on the other hand, may depend upon the interest rate that can be obtained by investing them in liquid securities. If interest is paid on foreign-exchange balances, while none is paid on gold, countries will be inclined to hold relatively large balances in foreign exchange, provided the authorities are not nervous about the safety of the gold value of these balances.

(xii) There is a certain justice in the payment of interest on exchange balances. The reserve country gains the ability to run a current-account deficit — which need not be regarded as a balance-of-payments deficit (see iv) — equal to the increase in its foreign exchange liabilities held as assets by outer countries. The extra goods and services thus made available to the reserve centre can be used for productive purposes on which a normal yield to capital can be obtained, and this permits the reserve country to pay interest on foreign balances without suffering losses. At the same time, the outer countries gain because they can hold a liquid earning asset rather than barren gold.

THE COMPOSITION OF RESERVES AND LIQUIDITY

(xiii) If it is not certain that the price of gold can be held constant in terms of the reserve currency, the possibility of speculative gains or

losses may induce central banks to hold a larger ratio of gold to total reserves than they otherwise would. More important, by changing the proportion of reserves held in gold, or by maintaining the proportion constant during a period of private speculation, the outer countries can directly affect the gold reserves and thus the policies of the key centre.

(xiv) When outer countries convert gold into exchange assets, they *create* international reserves and liquidity because they directly augment the gold holdings of the reserve centre while leaving the total quantity of their own reserves unaffected; when, on the other hand, they convert exchange reserves into gold, they *destroy* international reserves by diminishing the gold reserve of the key centre while leaving their own total of reserves unaffected.

(xv) In this way outer countries can influence the policy of the reserve centre. By converting gold into foreign exchange, or even by accumulating only foreign exchange, they can prompt the reserve centres to follow more expansive policies. And by converting exchange into gold, they can discipline the reserve centres into following more conservative financial or trade policies.

(xvi) The reserve centre controls, as part of its monetary policy, the amount of foreign exchange available, whereas the outer countries control the amount of gold reserves held by the reserve centre. The excess demand for gold on the part of the reserve centre is a residual demand, taking up what private hoarders and foreign central banks do not want.

THE BALANCE OF CONTROL IN THE SYSTEM

(xvii) It appears in the short run as though the balance of control in the system lies with the outer countries. Their position depends on their aggregate balance-of-payments surplus or deficit, which they can adjust by domestic policy as they see fit. They can also control the change in reserves of gold held by the reserve centres through appropriate policies determining the proportion of gold in their own and in total world reserves.

(xviii) In the long run, however, the reserve centres probably have the upper hand. For it is in their discretion to change their policy with respect to gold. They can create waves of optimism or pessimism regarding the gold price by threatening to change their gold policy and, if need be, by carrying out the threat. A number of alternatives are open.

(xix) In the first place, a reserve centre can always prevent gold *dumping* on the part of outer countries from reducing the price, for it has an unlimited ability to finance gold purchases even though it may not want

to exercise that ability. The problem arises, rather, when speculation or conversions are in the other direction, as when gold is made scarce by bullish speculation about the gold price or central-bank conversion of foreign exchange into gold. Since the reserve centre can never hold unlimited quantities of gold, it cannot indefinitely pay out gold.

(xx) One defensive measure in this case is for the reserve centre, if it has a large dominating capital market, to restrict lending, creating a scarcity of its currency on world markets and starving particular countries for reserves or forcing them to undertake contractive measures. In other words, the reserve centre, being squeezed for gold, can squeeze the rest of the world for exchange and bring on a liquidity crisis. This can be a logical outcome of a miscalculation on the part of the outer centres in trying to squeeze the reserve centre for gold. The danger of this policy for both the reserve centres and other countries is that it may initiate deflationary tendencies which may be difficult to reverse.

(xxi) A second possibility is for the reserve centre to continue paying out gold freely. After a certain point is reached, the exchange value of gold may become extremely uncertain, for the reserve country can always decide not to buy it back. The outer countries may then be left holding the bag — a bag filled with a drastically depreciated reserve asset (gold) that no longer has a value supported by the reserve centre.

(xxii) A final possibility is that the reserve centre may change its policy of buying and selling gold at the same price spread. If a larger spread between the buying and selling prices is created, it will cause uncertainty about the value of gold with respect to the currency and commodities of the reserve country, and will make gold less useful for some countries as an international medium of exchange. The reserve currency and gold will be less perfect substitutes, and countries will be forced to choose as to which of the reserve assets they think more secure in terms of other currencies or commodities.

THE "MYTHOLOGY" OF GOLD

(xxiii) It is sometimes felt to be impossible to lower the price of gold in terms of other commodities because of a special mythology associated with gold. This belief rests on a confusion.

(xxiv) In the first place, many other commodities have been used historically as money, and the mythology attached to these commodities has not proved durable. Particular moneys of the past have included seashells, bricks, beaver pelts, salt, coconuts, blankets, oxen, copper, silver, cigarettes, whales' teeth, boars' tusks, wheels, iron rings and cocoa

beans.¹ We do not hear today of the boars' tusk mythology or the feather mythology or any other except a gold mythology.

(xxv) In the second place, gold has depreciated at various times in history in terms of its exchange value for commodities. After each of the gold strikes in the nineteenth century, gold depreciated in terms of commodities. And since 1934 gold has of course undergone a continuous depreciation in terms of its command over other commodities. The purchasing power of gold in terms of commodities has depreciated at exactly the same rate as the exchange value of the U.S. dollar, for the obvious reason that the price of the dollar has been fixed in terms of gold.

(xxvi) The confusion about the mythology of gold is disposed of by reference to the law of supply and demand. When the price of gold is expected to rise, traders or speculators buy it and hoard it; and when its price is expected to fall, they sell or dishoard it. This is evident from even a casual glance at the movement of gold prices on the London gold market and in various black markets throughout the world. A mythology of gold is not firmly held by the modern generation, although there is a belief among this generation that central bankers subscribe to the mythology or, by a convoluted, to a belief that the modern public subscribes to the mythology!

(xxvii) To say that the gold mythology is a myth does not, however, mean that gold cannot fulfil a useful purpose in the international system. It may even be in the interest of monetary authorities to perpetuate the myth so as to relieve the gold-buying treasuries of part of the price-pegging burden by shifting some demand onto private speculators. But in any case, the fact that many people subscribe to the mythology can be exploited in any reform of the international monetary system. If gold did not exist, we would not have to create something like it; but since it does exist, there is no reason why we should not use it.

PROBLEMS OF THE GOLD STANDARD, FLEXIBLE EXCHANGE RATES AND A WORLD BANK

(xxviii) To exploit the anonymity and mythology of gold does not, of course, require a return to the gold standard that prevailed in the nineteenth century. Nor would a return to that form of gold standard be desirable. Countries have, in the past, elected to exercise an important measure of discretion in monetary matters, and will continue to do so. Rather than submit to the discipline of deflation or depression, deficit countries would resort to trade restrictions of the kind prevalent today,

¹ See, for example, Wright Patman, *A Primer on Money*, Committee on Banking and Currency: Sub-committee Print, Aug. 5, 1964.

or worse; and rather than submit to inflation, countries would choose to sterilize all or part of the monetary impact of gold flows. The result would be a system with adjustment features no better, though probably no worse either, than those which exist today, and we would, in the process, have given up control over the level of world reserves. A pure gold standard would be a step backward from the present system.

(xxix) An alternative way of using gold would be to create a world central bank out of the highly competent staff of the existing IMF, with note-issuing or deposit-creating authority based on gold. Such a bank could take over existing gold holdings and replace them with gold certificates credited to the account of each member, while each member maintained its currency convertible into gold certificates and the world central bank maintained gold certificates convertible into gold. To adjust the level of world reserves, the world central bank deposits could be based on a fractional reserve ratio that could be increased or decreased each year depending on whether the new governors of the bank considered the supply of liquidity in the form of gold certificates to be excessive or deficient. There is much to be said for developing this kind of central bank system founded on a gold base, and in the long run, this is the direction that international monetary reform may have to take.

(xxx) Such a bank, however, is not practical at the present time and probably will not be practical in the next decade. The problem of management and policy in a state of world tension is too vexing. The same conflicts that appear in international monetary relations today would paralyze the power of a world central bank to act. Surplus countries would demand that the bank contract, while deficit countries would urge that it expand. The same conflicts which in 1944 condemned the IMF to an inadequate role, and which have since eroded its power to a subsidiary role (much to our misfortune), would permeate the executive committee of a world central bank. A world central bank is not negotiable today, and if it were negotiable it would be doomed to paralysis. In the long run it may be a necessity, but for the present it appears to be an impossibility.

(xxxi) The proposal to let all exchange rates fluctuate has not generated any support among central bankers, despite its popularity among economic theorists, although this is partly because there has been little attention paid to the problems of transition to such a system. The Canadian example has done much to dispel the notion that flexible exchange rates imply exchange-rate instability. But countries are not going to get together and say, "Let us now have flexible exchange rates". To all central bankers, to most businessmen, and to many economists, the maintenance of fixed exchange rates is a virtuous act that will not be

discontinued unless proof can be established beyond a shadow of doubt that the gains will be substantial.

(xxxii) Many smaller countries will continue to peg their currencies to the currency of a larger country with which they are associated economically or politically. It would be a mistake to encourage a general proliferation of fluctuating national currency prices without taking into account the concept of optimum currency areas. In this connection, the political realities underlying the existence of major currency blocs must be kept in mind.

(xxxiii) Two major blocs, the dollar area and the sterling area, already exist, with the dollar the major exchange-reserve asset. But it is possible, and indeed likely, that a new gold bloc, based on a new currency unit, will develop on the continent of Europe. The sterling area is likely to persist indefinitely, but political motives may prompt Britain to connect sterling more closely to the dollar or to the hypothetical thaler.

(xxxiv) A system of two or three blocs can be envisaged for the future in which *intra-area* payments are settled through shifts of deposits in the dominant currency centre, while *interarea* payments are settled in gold. In the far-off future, gold might conceivably be replaced by gold certificates issued by a world central bank, built on the foundation provided by the IMF.

(xxxv) As noted, a pure gold standard in its original form has to be ruled out as the means of effecting balance between the major blocs. But a modified gold standard based on widened gold margins can be envisaged. If the margins were set sufficiently wide, there would be room for exchange-rate adjustments between the blocs. At the same time, the dominant centres would have to govern their monetary policies to prevent persistent losses of gold when the gold export points were reached. The centralization of each area's gold holdings would probably suffice for the area's reserves without requiring, for the time being anyway, a change in the price of gold.

(xxxvi) The Fund can itself consent to a widening of the gold margins (although it cannot itself formally permit a widening of the exchange margins). No change in the Articles of Agreement would be required and no Act of Congress in the United States would be necessary.

B. Conclusions

1. *In the long run* we can expect, and should encourage, a world central bank which could fix the price of gold, hold assets in the form of gold and securities of the major financial centres, and create deposits reflecting claims on the bank's gold reserves in the form of gold certificates.

But an institution of this kind is a long way off and cannot come into being before a far greater political coalescence has developed among the major financial powers.

2. *In the intermediate run* we can expect to see the development of dominant financial centres, each servicing payment settlements among the peripheral countries associated with it. The currency of the dominant centre would be the medium of international exchange for intra-area transactions; and initially gold, but later gold certificates, would be the medium of international exchange for settlement of payments between the dominant centres. Peripheral countries would maintain local currencies convertible into the currency of their dominant centre, within exchange-rate margins which would depend on how closely their capital markets were, or were desired to be, integrated with the dominant centre. The centre countries would maintain their currencies convertible into gold (later gold certificates) between margins which would depend on the degree of financial integration politically possible or desirable between major centres.

Two dominant centres, New York and London,¹ already exist, and there are now two major international currencies, the dollar and the pound. A third centre on the continent of Europe is likely to develop if plans for financial integration within EEC progress smoothly, if an intra-area unit of account and medium of settlement (such as the hypothetical thaler) develops, and if economic nationalism makes wider financial integration within the Atlantic Community impossible. It is also conceivable, though conditional upon international politics and the course of the cold war, that a fourth bloc, based on an internationally convertible ruble and centred in Moscow, will develop.

Neither the composition of the countries forming the currency areas, nor even the location of the central markets, would be rigidly fixed. Currency arrangements evolve out of historically important trade and financial channels and political associations. The peripheral countries gain the advantage of holding international reserves in earning assets rather than barren gold, and also of the use of credit facilities of the dominant centre; but their allegiances can change for economic or political reasons. Political conditions will also affect the degree of financial integration between financial centres.

The location of a future international capital centre on the continent cannot be predicted with certainty: Paris, Brussels, Amsterdam, Frankfurt,

¹ London, of course, is a subdominant centre with respect to New York in the sense that the pound is pegged to the dollar rather than to gold, and its use as a central bank asset is less important. On the other hand, the commercial use of sterling, in its role for invoices, invisible transfers and trade credit, may well exceed the importance of the dollar in similar roles.

Milan? Even Zurich, perhaps, whether in or out of EEC. But economies of scale are likely to cause a single centre of dominance to arise. The future of sterling is also a crucial consideration and will depend upon which of three courses is open and attractive to Britain: independence, closer integration with EEC, or closer integration with North America? The British choice or available course of action may be an important conditioning factor in setting the nature and location of the European financial centre.

3. *In the short run* the dollar is in a position of dominance. The use of the dollar as an international reserve currency is likely to expand rather than contract. Over time the efficiency of the New York market in servicing its own area and other areas will improve as American finance and industry look increasingly outward, as American corporations become increasingly international-minded (despite the huge U.S. internal market) and as the world market in dollar loans expands. U.S. policy, however, has been headed in the wrong direction; it has tended to weaken, rather than to strengthen, the position of the dollar as a world currency. U.S. policy needs to shift course and take steps to bolster the position of the dollar in relation to gold as an international reserve asset.

The first step is to make the dollar and gold *less* perfect substitutes by permitting the price of gold in terms of dollars to fluctuate to a greater extent than is now permitted. The United States should petition the IMF, in which it holds almost one-quarter the voting power, to permit a widening of the gold margins beyond the now-permitted ± 1 percent. Wider gold margins would remove the one-way option which speculators believe they now face, and create the threat that the value of gold in a hoarder's cache might go down as well as up. A wide margin would encourage central banks to make a clear choice between holding dollars or gold; in particular, they would decide whether they (a) wanted gold either for political reasons or because they expected an increase in its price, or (b) were prepared to hold more dollars than they really preferred, rather than embarrass the United States Treasury by converting dollars into gold.

A widening of the gold margins would not *in itself* imply greater exchange flexibility because countries in fact peg their currencies directly or indirectly to the dollar rather than to gold. But with widened gold margins some countries might shift to the enabling clause in the IMF charter which permits countries to buy and sell gold within the limits prescribed by the Fund instead of maintaining exchange rates within one percent of par values; in this case there could be exchange flexibility between countries adhering to this clause. It is conceivable that the members of EEC might join the United States in adhering to this clause, so that the upper and lower limits of the gold price would be jointly main-

tained. Between those countries' pegging gold — but not between those pegging the dollar — exchange rates would be free to fluctuate within the margins.

If, say, France moved to the gold-pegging clause, abandoning her current limits for buying and selling dollars, the franc would appreciate to the extent that the French balance of payments was in surplus, and depreciate to the extent that it was in deficit. If France accepted only gold in settlement of net international transactions and if her balance of payments continued in surplus, the appreciation of the franc would reduce the French surplus and make deflationary policies in France easier to implement and less necessary. The United States would lose gold only if the price of gold hit its upper limit.

But France might want to peg gold within a *narrower* margin than the United States. To that extent the fortunes of the franc and gold would fluctuate more closely together on the world market. If France and some other countries dumped dollar holdings to acquire gold, the franc and all other currencies pegged narrowly to gold would appreciate relative to the dollar, again reducing the surpluses of France and the other countries and improving the U.S. balance on current account.

A third possibility is that France and some other countries might continue to peg their currencies to the dollar as at present, but dump existing stocks of dollars for gold. This would push up the dollar price of gold without altering the franc-dollar exchange rate. As the gold price reached its upper limit, gold would become a risky asset to hold unless there was doubt about the upper limit, since the one-way option within the margin would be reversed in favour of the dollar. Meanwhile, the dollar-pegging countries would have to buy up some of the excess dollars they had dumped to prevent their currencies from appreciating; some of the dollars they initially sold for gold would have to be bought back by the central banks. Private speculators and central banks in the dollar area might be prompted to sell gold either to realize capital gains or to avoid the risk of losses. The residual demand for gold would be supplied, as it is now, by the United States, but at a higher price and under circumstances in which U.S. holdings of gold should be more than ample. It must be remembered that the whole U.S. gold stock can be mobilized for use in payment of any demands upon it, for the twenty-five percent reserve requirement behind Federal Reserve notes can be suspended even without any act of the U.S. Congress.

The width of the gold margins would depend on what is negotiable with the IMF Executive Board. Elsewhere¹ I have suggested 7½ per-

¹ "The Gold Herring", Testimony to the Joint Economic Committee of the U.S. Congress, November 15, 1963.

cent on either side of par, and I still consider that margin consistent with the objectives of the Fund and yet wide enough to ensure the desired flexibility of exchange rates for countries which choose to adhere to the gold-pegging clause of this modified gold standard. In round numbers, a U.S. buying price for gold of \$32.50 and a selling price of \$37.50 would provide enough flexibility, weaken the one-way option for speculators, allow a clearer distinction between dollars and gold as a reserve asset, and yet retain the virtues of a gold standard system as the margins were approached.

Many dollar-pegging countries would simply exchange gold for dollars. Gold can be an expensive commodity to hold, as many countries have realized. For example, Canada has lost over \$500 million of interest income by her past policy of holding gold rather than dollars as reserves. In other words, had Canada invested her gold holdings, which have averaged about \$1 billion over the past fifteen years, the cumulative value could have almost doubled, the interest payments being used to build up bigger reserves. Canadian reserves could have been much higher than they are had the Canadian authorities better recognized the advantages of alternative investments.¹

What holds for Canada holds for many other countries. For Canada and a number of other countries, the dollar standard has served as a perfectly acceptable international standard in the postwar world, and it is in the interests of these countries to ensure that the United States is not forced, through the myopia or precipitate self-interest of other powers, to discard a system that has up to now proved viable.

Wider gold margins would imply an increasing use of the dollar throughout much of the world and a decreasing use of the dollar in countries that found a dollar standard unacceptable or inimical to their financial interests. A dollar standard might be unacceptable to a country like France, whose leaders have explicitly advocated a gold standard, resented the use of the dollar and sterling as international currencies, and objected to the political impact of American foreign investment. Wider margins present a means by which France could simultaneously move onto a gold standard, gain the fruits of a clearer distinction between the dollar and gold, permit an orderly appreciation of the French franc, if this is judged desirable, and hence weaken the inflationary pressures in France that have been blamed on U.S. monetary policy, thereby removing

¹ In 1950 there was virtually no prospect of an increase in the dollar price of gold, in contrast to the fluctuating rumours circulating in the exchange markets today. In 1950 holding dollars seemed absolutely safe; now it does not. On the other hand, many countries, including Canada, have much to gain by providing additional support to the U.S. reserve position by purchasing dollar assets with gold for which they have no financial need.

the "embarrassing" surpluses in the French balance of payments that are to some extent the counterparts of U.S. "deficits". The U.S. dollar might not be able to monopolize the role of reserve currency as the EEC developed its own centralized liability; and in any case, sterling will always remain of considerable importance as a reserve currency in what is now the sterling area.

The U.S. authorities, on their own initiative, can initiate the new policy while the Fund is considering the value of wider gold margins. They can unilaterally widen the gold margins to ± 1 percent, buying gold at \$34.65 and selling it at \$35.35. This spread is not wide enough to establish a sufficient distinction between gold and the dollar, but it is wide enough to provide an opening for those countries that wish to start pegging gold rather than the dollar. For even margins of only one percent on either side of the gold-par price, if combined with three-quarter-percent margins on either side of the par value of currencies, would create implicit gold margins, on other currencies, wider than one percent. This small beginning step would encourage other governments to decide whether their interests would be best served by a fixed local-currency price of gold or by a fixed local-currency price of the dollar.

In the event of a crisis forced upon the international scene by sudden dollar conversions, the United States might have to act unilaterally. On its own initiative, the United States might consider widening the gold margins substantially, creating a needed distinction between gold as a historically anonymous, but barren, international reserve asset and the dollar as a proved and viable standard in an evolving world monetary system. Such action would result in a dollar standard in much of the world, but a dollar standard is preferable to most of the leading alternatives. In any case, the dollar standard has, in the past, performed much better than its reputation.

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SPECIAL PAPERS IN INTERNATIONAL ECONOMICS

No. 6, JANUARY 1965

THE
"BAND" PROPOSAL:
THE LIMITS OF
PERMISSIBLE
EXCHANGE RATE
VARIATIONS

GEORGE N. HALM

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY • 1965

This is the sixth number in the series SPECIAL PAPERS IN INTERNATIONAL ECONOMICS.

The author, George N. Halm, is professor of economics at the Fletcher School of Law and Diplomacy at Tufts University. Among his publications are: INTERNATIONAL MONETARY COOPERATION, MONETARY THEORY, and ECONOMICS OF MONEY AND BANKING.

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PREFACE

The Joint Economic Committee recommended recently that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange-rate variations."¹ In view of the fact that no official of the United States Government or of the Federal Reserve has been willing to discuss any form of greater exchange-rate flexibility, at least in public, and that such discussion was expressly excluded from the Ministerial Statement of the Group of Ten,² the Joint Economic Committee's suggestion constitutes a major breakthrough. It is to be hoped that the proposal to widen the band will be widely discussed in the near future, both in official and in academic circles, and that this discussion will contribute substantially to the solution of our international payments problem.

The band proposal is very old. Robert Torrens suggested as early as 1819 that the range between the so-called gold points should be widened. Since then the proposal has been repeated quite often, but it has only once been thoroughly discussed, in John Maynard Keynes' carefully reasoned recommendation "that the difference between a Central Bank's obligatory buying and selling prices should be made somewhat greater, say 2 per cent, so that there would be at least this difference between the gold points irrespective of actual costs of transporting gold."³

That the proposal has been neglected is not only due to the official lack of enthusiasm, noted above, but also to the fact that more extreme and more challenging plans have monopolized the theoretical discussion. Now, however, the time has come for a serious consideration of this recommendation, because it may offer possibilities for a constructive compromise between the more extreme theoretical positions ("fixed versus freely fluctuating exchange rates"), and also between the attitudes of economists and central bankers, who are still separated by an apparently unbridgeable gulf.

The present study seeks to contribute to the discussion of the band proposal in two ways: by a survey of the long but, in content, rather

¹ *The United States Balance of Payments*, 88th Congress, 2d Session, Senate Report No. 965, Washington, March 19, 1964.

² On the ground that "the Ministers and Governors agreed that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements." The Statement was issued August 10, 1964.

³ John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), chapter 36.

brief history of its different versions, and by studying the pros and cons of one particular version in somewhat greater detail. Of the many possible recommendations to widen the margin for exchange-rate variations, the combination of a wider band with a *permanent* parity is selected for full discussion. The assumption here is that greater exchange-rate fluctuations around an unalterably fixed parity can be substituted for the present adjustable-peg system, which is considered to be a bad compromise between rigidity and flexibility.

Technical details will be kept to a minimum because it is assumed that they will be worked out through practical experience, as central banks cooperate in managing the system. Monetary authorities may develop greater interest in a widened band as they learn to regard their operations in the foreign-exchange markets as a powerful tool in maintaining balance between external and internal equilibrium.

It need hardly be stated that the band proposal is not a panacea. It aims at demarcating one promising area for constructive compromise. The proposal would be compatible with other reform plans, such as the various proposals for the creation of reserve assets, and other suggestions in connection with our efforts to overcome the difficulties and dangers of the present key-currency system.

G.N.H.

Medford, Massachusetts

November 1964

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I. Introduction

The Adjustable-Peg System

The monetary experts who participated in the great debate preceding the Bretton Woods Conference of 1944 were opposed to both permanently fixed and freely fluctuating exchange rates. The International Monetary Fund was a compromise which attempted to establish the principle of "managed flexibility" for the exchange rates of the member countries.

The argument against permanently fixed gold parities is well known. John Maynard Keynes objected to the gold standard on grounds that it confines the natural tendency of wages to rise beyond the limits set by the volume of money, and in doing so creates unemployment. The gold standard involves a financial policy which compels the *internal* value of the domestic currency to conform to an *external* value which is rigidly tied to a fixed quantity of gold.⁴ Keynes proposed that "instead of maintaining the principle that the internal value of a national currency should conform to a prescribed *de jure* external value," we should provide "that its external value should be altered if necessary so as to conform to whatever *de facto* internal value results from domestic policies."⁵ Since the International Monetary Fund has "to approve changes which will have this effect," Keynes felt that the Fund proposal was "the exact opposite of the gold standard."⁶

Those who reject a system with permanently fixed exchange rates still follow Keynes' argument that maintenance of exchange-rate rigidity may force a member country to abandon, or dangerously to curtail, its domestic employment and growth policies. A member country may, simultaneously, suffer from unemployment and inflation

⁴ Lord Keynes, "The Objective of International Price Stability," *Economic Journal* (June-September, 1943), pp. 185-187. He added that "this complaint may be just as valid against a new standard which aims at providing the quantity of money appropriate to stable prices."

⁵ Speech by Lord Keynes on the International Monetary Fund Debate, House of Lords, May 23, 1944. Reprinted in Seymour E. Harris (ed.), *The New Economics: Keynes' Influence on Theory and Public Policy* (New York: Alfred A. Knopf, 1948), pp. 369-379.

⁶ *Ibid.* It is interesting to note that John H. Williams, on the other hand, considered the new currency proposals from the very beginning as "essentially variants of the gold standard system." *Post-War Monetary Plans and Other Essays* (New York: Alfred A. Knopf, 1945), p. 11.

if monopolistic market forces forbid downward cost and price adjustments. If the inflation is greater than inflations in other countries, a balance-of-payments deficit will be created. Elimination of this deficit, at fixed exchange rates, will require contractionist domestic monetary policies and will lower the employment level still further.

A combination of permanently fixed exchange rates and satisfactory employment levels requires sufficiently competitive market conditions to permit the use of restraining monetary policies without creation of mass unemployment. But sufficient price elasticity downward may no longer exist in modern market economies.

In spite of the rejection of *permanently* fixed exchange rates, there existed, at the time, a general aversion to freely fluctuating exchange rates. The nearly complete silence of proponents of this form of flexibility excluded the system from discussion.⁷ Besides, freely fluctuating exchange rates would have been ruled out anyhow, as it was generally assumed that they would expose the system to competitive exchange depreciation, the much-feared evil of the 'thirties.

The International Monetary Fund Agreement of 1944 was a compromise between the longing for a free hand in domestic economic policies and an equally strong desire for exchange-rate stability. Therefore, it was decided that the currencies of the members would at all times be tied firmly to gold, but that the International Monetary Fund "should concur in a proposed change . . . if it is satisfied that the change is necessary to correct a fundamental disequilibrium."⁸

Twenty years of experience have shown that this compromise between rigidity and flexibility was not quite as successful as the experts had hoped. However, the adjustable-peg formula permitted at the time a compromise without which the creation of the International Monetary Fund would have been impossible.

⁷ The only exception, to the knowledge of the present writer, was Mr. Benson, who complained that the new plans did not propose relatively stable exchange rates nor reasonably stable exchange rates but fixed exchange rates which could only be altered by permission. He foresaw the main difficulty of the adjustable-peg system, viz., that a system of orderly devaluation and upvaluation would be exposed to disturbing speculative movements since nobody will want to buy the goods of a country for which a devaluation is impending until the devaluation has taken place. *Parliamentary Debates on an International Clearing Union*, House of Commons, May 12th, 1943, and House of Lords, May 18th, 1943. British Information Services, New York, July 1943, pp. 59-63.

⁸ *Articles of Agreement. International Monetary Fund and International Bank for Reconstruction and Development*. United Nations Monetary and Financial Conference, Bretton Woods, N.H., July 1 to 22 (Washington: United States Treasury, 1944), Art. IV, Sec. 5 (f).

Those who defended the Keynesian position that the new institution "should not wander from the international *terrain*" and "should be limited to recommendations, or, at the most, to imposing conditions for the more extended enjoyment of the facilities which the institution offers"⁹ made *permanently* fixed exchange rates impossible because they insisted on the elimination of that degree of harmonization of national economic policies without which a system of permanently fixed rates cannot work. Yet fixed rates which are not permanently fixed lose much of their alleged advantage as a firm foundation for the international flow of commodities, services, and loanable funds.

This structural weakness of the International Monetary Fund was not critical at first because of the prevalence of exchange controls. With the introduction of convertibility of the currencies of the more advanced industrial countries, however, overvaluations and undervaluations have become more dangerous for the international payments system. It is now rather generally agreed that the adjustable-peg system is exposed to disequilibrating speculation, unless the International Monetary Fund succeeds better than in the past in integrating the domestic economic policies of its members.

Assuming fixed rates of exchange and inadequate harmonization, the adjustable-peg system cannot work well. Maintenance of convertibility of "wrong" rates of exchange requires flows of international reserves from deficit to surplus countries. These flows advertise the deviation of the pegged rate from the equilibrium rate and may herald the approach of the day when the peg will be changed. This situation constitutes an invitation to sell overvalued currencies and precipitates the impending devaluation.

The adjustable-peg system, by delaying price variations in the foreign-exchange market, exposes the members' economies to sudden shocks which could have been avoided either by gradual changes of the exchange rates or by gradual cost and price adjustments.

These shocks, and the disequilibrating capital movements which are induced by impending peg adjustments, have led to an attitude on the part of the International Monetary Fund and many of its members which now makes exchange-rate adjustments very rare events. Thus we find ourselves back in a system with more or less permanently fixed exchange rates—the very system which we wanted to abolish at Bretton Woods.

⁹ *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), Preface.

The adjustable-peg system, as proposed in Keynes' International Clearing Union, would have been even more objectionable than the Fund's. The *Keynes Plan* suggested that alterations of the exchange value of the member currencies be made part of the "internal stabilizing mechanism" of the system. For instance, if a member's "deficit balance has exceeded a *quarter* of its quota on the average of at least two years, it shall be entitled to reduce the value of its currency in terms of bancor provided that the reduction shall not exceed 5 percent without the consent of the Governing Board" and the Board, as a condition of allowing a member State to increase its debit balance in excess of *half* of its quota, may even *require* "a stated reduction in the value of the member's currency."¹⁰

The *Keynes Plan* would have made it easy for speculators to predict impending devaluations. For the International Monetary Fund's concept of "fundamental disequilibrium" we can at least say that it is very difficult to interpret while "a publicly recognized and recognizable criterion for exchange adjustment has . . . the disadvantage that it may act as a signal for speculative capital transfers in anticipation of changes in exchange rates."¹¹

Keynes' proposal cannot be defended on the ground that it implied more *frequent* adjustments of exchange rates and that frequent changes would be a good substitute for flexible exchange rates. His reference to a disequilibrium of two years' duration shows that he was suggesting a system that would have been made virtually unworkable through hot-money movements.

* * * *

The version of the proposal to broaden the limits of permissible exchange-rate variations, which is to be considered in the present study, can be regarded as a substitute for the adjustable-peg system. It seeks to do what the experts of Bretton Woods wanted to accomplish, viz., to find a compromise between fixed and flexible exchange rates. It suggests a permanent, built-in flexibility within a broadened band in order to avoid the need for an abrupt change of the peg. Should the permitted exchange-rate variations, however, fail to bring

¹⁰ *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), II, 6 (8). Bancor was to be "international bank money . . . fixed (but not unalterably) in terms of gold and accepted by . . . members of the Union for purposes of settling international balances" (I, 4).

¹¹ Ragnar Nurkse, *Conditions of International Monetary Equilibrium*, Essays in International Finance, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1945), p. 8.

about the needed adjustments and should the monetary authorities be unable to keep their domestic policies within the range permitted by the broadened band, the band would have to be moved. Such a "movable band" system would, therefore, remain exposed to some of the shortcomings of the adjustable peg.

The Key-Currency System

Fixed exchange rates can be combined with deviations of national economic policies if the members of the international payments system have large reserves of gold or foreign exchange at their disposal. What amounts will be adequate will depend in the main on the degree of integration of the economic policies of the members of the system, i.e., on the efficacy of the adjustment mechanism. Furthermore, the need for the holding of official reserves will be partially determined by private capital movements that are characteristic of the payments system in question. If these private capital flows tend to be equilibrating, fewer official reserves need be held. If the system is prone to suffer from disequilibrating speculative movements, the demand for liquid balances or gold may become dangerously great. A system of freely fluctuating exchange rates, on the other hand, needs no official reserves whatever, since international payments equilibrium is established automatically, at all times, through instant exchange-rate variations.

We see that a system with a broadened margin of permissible exchange-rate variations would reduce the demand for international liquidity reserves if it succeeded in promoting external equilibrium and in harnessing equilibrating (and preventing disequilibrating) private capital movements. But it could not claim to get along without official reserves, as these would be needed at the upper support point and for any desired government selling activities within the band.

Proponents of a fixed-rate system differ widely as to the amount of official reserves that they consider adequate. Some suggest that only gold reserves should be held, while others would be extremely liberal in the degree of freedom which they would purchase through very large reserves.¹² This difference within the fixed-rate camp is often

¹² Egon Sohmen, an advocate of freely fluctuating but stable exchange rates, states correctly "that the call for ever bigger international funds, stand-by agreements and all the rest, for bridging balance-of-payments deficits is somewhat out of tune with the aim of achieving a maximum of monetary integration." Egon Sohmen, *International Monetary Problems and the Foreign Exchanges*, Special

much greater than the disagreement between some proponents of fixed and of flexible exchange rates.

Within the camp of the advocates of freely fluctuating exchange rates we find the same diversity of opinion. Some writers seem to come close to the extreme position that the very fact that no official reserves need be held frees the domestic authorities from any consideration of the balance-of-payments effects of their actions, while others are of the opinion that the exchange rates, though freely fluctuating, ought to be as stable as possible.

Already at Bretton Woods it was evident that astonishing differences of opinion existed as to the amounts of international reserves that would be adequate.¹³ Keynes' Clearing Union was unacceptable to the United States because up to 24 billion dollars of credit extension *on the initiative of the deficit countries* exceeded by far what she considered safe from the standpoint of domestic monetary stability.¹⁴ The resources of the International Monetary Fund, on the other hand, proved to be far too small. One main reason was that the Fund did not have the power to coerce its members into such monetary discipline and harmonization as would have enabled them to get along on the modest additional reserves that the new institution provided. However, on her own terms, the United States extended aid that exceeded

Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 25.

¹³ The *Keynes Plan* suggested quotas of about 36 billion dollars for the world as a whole, while the corresponding figure for the International Monetary Fund was about 11 billion dollars. However, these two figures were not even comparable, owing to the different structures of the proposed institutions. In the International Monetary Fund the potential surplus countries were obliged to extend credit to the amount of their own quotas (which, for the United States, was 2.75 billion dollars). In the Clearing Union, on the other hand, a potential surplus country agreed to accept payment of balances from other members in the form of bancor credits with the Union, the amount being limited only by the sum of the debits of the deficit countries. Under the extreme conditions that prevailed after World War II, this could have meant a potential expansion of credits by the United States of up to 24 billion dollars, though correctives would have come into play before 8 billion dollars would have been reached. See Joan Robinson, "The International Currency Proposals," *Economic Journal*, Vol. LIII (June-September, 1943), p. 165. Reprinted in Seymour E. Harris (ed.), *The New Economics* (New York: Alfred A. Knopf, Inc., 1948).

¹⁴ Keynes defended the absence of a rigid maximum for credit balances by arguing that this absence would not impose on a potential surplus country an unlimited liability outside its own control, as it could always, by its own policies, reduce its surplus. *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), III, 8. This is only partly true, because inflationist policies in deficit countries could exert stronger inflationary pressure on the surplus countries than the latter might care to accept for the sake of external equilibrium.

what she had not been willing to promise unconditionally under the *Keynes Plan*, and thus became the major key-currency country.

Many observers hold that the present key-currency system is dangerous and may lead to a collapse of the international payments system similar to, or worse than, the breakdown of the gold-exchange standard during the inter-war years.¹⁵ The argument is impressive. If gold stock and gold production are inadequate to supply the needed growth of international reserves; if the supply of dollar balances as international reserve must rest on a permanent balance-of-payments deficit of the United States; if a permanent deficit lowers the confidence in the dollar; and if the confidence in dollar convertibility, at a fixed gold parity, is further lowered by the decrease in United States gold holdings (in comparison with the permanent growth of gold-convertible foreign-held dollar balances)—then the system is bound to collapse unless it is speedily consolidated or liquidated.

Fortunately, the argument is not entirely convincing for three reasons. (1) It is wrong to assume that the demand for international reserves must continuously increase. Should we succeed in building greater flexibility into the international payments system, and in improving thereby the adjustment mechanism, the demand for reserves may be greatly decreased. (2) It is erroneous to conclude that confidence in the key currency is nothing but a function of the key currency's net reserve position. (3) The key-currency system has features which distinguish it favorably from the old gold-exchange standard.¹⁶

Another criticism of the key-currency system concerns its effect on the domestic economic policies of the key-currency country. Some observers point out that the key-currency country is put into the seemingly pleasant but actually rather demoralizing position of not having to pay for its deficits, as its debts are held as international reserves by other countries. Thus it is said that the United States has been prevented from carrying out sound monetary policies which would have been obligatory had the deficit been financed through a lowering of United States gold reserves.¹⁷

¹⁵ The most famous statement of this thesis is Robert Triffin's in his *Gold and the Dollar Crisis* (New Haven: Yale University Press, 1960), pp. 8-9.

¹⁶ These features concern, among others, the very existence of the International Monetary Fund as an international forum; the responsible leadership of the United States after World War II in contrast to her inconsistent behavior in the 'thirties; the general maintenance of higher levels of employment; the elimination of most beggar-my-neighbor policies; and the increase in international monetary cooperation.

¹⁷ See Jacques Rueff, "Gold Exchange Standard a Danger to the West," *The*

Against this argument can be held the opinion of those who feel that the key-currency country does not enjoy enough freedom in its internal policies. The United States is deprived of the safety valve which the Bretton Woods system offers to member countries in severe external disequilibrium, since as a key-currency country she cannot devalue the dollar. Neither can she force surplus countries to shoulder their share in the adjustment process if they should decide not to expand their domestic monetary circulation.¹⁸

Here we meet again with the fundamental question which characterizes the whole international-payments discussion: should there be more rather than less freedom for domestic economic policies? Agreement exists only to the extent that both schools of thought feel that the key-currency system should not continue in its present form.

* * * *

What contribution to the solution of the key-currency problem can we expect from a proposal that the margin of permissible exchange-rate variations should be widened? The present study will attempt to show that the following favorable effects could materialize: (1) the total of needed reserves could be decreased and the need for additional key-currency balances reduced; (2) greater variations of exchange rates could contribute to the adjustment mechanism without forcing deflationary policies on countries in deficit; and (3) if the system could successfully control private capital movements, it could eliminate the greatest and most dangerous source of disequilibrium in the United States balance of payments.

The band proposal is not put forward as a panacea. No international payments system can create external equilibrium if its members refuse to carry out necessary adjustment measures. Nor can it be expected that, for instance, transfers of huge unilateral payments can be made to materialize instantly in export surpluses. Nevertheless, as a workable compromise between international monetary discipline and some freedom for domestic economic policies, the proposal should contribute substantially to a solution of our problem.

Times (London), June 27-29, 1961; and Michael A. Heilperin, "The Case for Going Back to Gold," *Fortune Magazine*, Vol. 66 (September, 1962). Both articles are reprinted in Herbert G. Grubel (ed.), *World Monetary Reform* (Stanford, Cal.: Stanford University Press, 1963), pp. 320-342.

¹⁸ See George N. Halm, "Special Problems of a Key-Currency in Balance-of-Payments Deficit" in *Factors Affecting the United States Balance of Payments*, Compilation of Studies Prepared for the Subcommittee on International Exchange

It can be argued that the present situation is too precarious to permit the introduction of a system which would allow greater variations of the value of the key-currency unit. Our answer will depend on how broad the margin is to be, how closely the central banks cooperate, and how successful the new arrangement will be in controlling disequilibrating capital movements.

It must also be remembered that any major change of an established system involves some dangers. Take as an example the seemingly most conservative of the proposed plans, the introduction of a semi-automatic gold standard through a general upvaluation of gold. The plan seems to solve the key-currency problem through the liquidation of dollar and sterling balances out of gold profits. But is it not naive to assume that the holders of key-currency balances will quietly wait for a devaluation of these balances in terms of gold? Thus, if the introduction of a system of freely fluctuating exchange rates is at the moment out of the question, so is a general increase in the price of gold. It is at least arguable that the introduction of a broadened band around existing parities could be handled so carefully and gently that it would not upset the present international payments system. In fact, if flexibility through a broadened band could replace the pseudo-flexibility through peg adjustments, confidence would be strengthened rather than diminished.

Fixed vs. Flexible Exchange Rates

The proposal to broaden the band of permissible exchange-rate variations is intended as a compromise between fixed and flexible exchange rates, a better compromise than the existing adjustable-peg system.

Ideally, the proposed compromise should combine the strong features of both fixed and flexible rates and should avoid their weaknesses. To find out what these advantages and disadvantages are, we must briefly survey the case for and against fixed, as compared with flexible, exchange rates.

A system of fixed exchange rates is recommended on the following grounds.

(1) Only fixed rates, we are told, provide a firm foundation for international trade and for desirable international movements of

and Payments. Joint Economic Committee, 87th Congress, 2d Session (Washington, 1962), Part 7, pp. 541-561.

capital. Even though international transactions always concern at least two national currency units whose purchasing powers do not always change in the same degree or even in the same direction, there exists the almost universal desire to make the foreign-exchange rate resemble the domestic currency unit, by imparting to it absolute price stability in terms of *both* national currency units by fixing the rate of exchange, for instance, by tying both currencies to gold.

(2) It is considered an advantage rather than a disadvantage that these fixed rates can be maintained, in the long run, only under the condition that the countries' monetary policies are harmonized. When combined with convertibility and limited foreign-exchange reserves, fixed exchange rates *force* the national monetary authorities to integrate their policies. Inflation in any country, worse than inflation in the rest of the world, and maintenance of the inflation-country's exchange rate are mutually exclusive.

(3) Fixed exchange rates supposedly make it relatively easy to see which course the monetary authorities will follow. The central banks must adjust their bank rates so as to bring about balance-of-payments equilibrium. "Cheap-money" policies are ruled out and interest rates are determined objectively, we are told, and not through political pressure to accommodate price and wage increases. Monopolistic forces and inflationist trends, therefore, can best be stopped by a monetary policy which derives its authority from the fact that external equilibrium *must* be achieved at fixed exchange rates and without exchange control.

(4) Last but not least, fixed exchange rates supposedly eliminate the danger of competitive exchange depreciation. It was the rejection of competitive exchange depreciation that led to the unanimous approval of fixed, only conditionally alterable, exchange rates at Bretton Woods.

Much of the argument for fixed exchange rates loses force as soon as adjustments of these rates are permitted, even though these changes are supervised by an international organization and are supposed to occur only in cases of so-called fundamental disequilibrium. If those who make inflationary mistakes can be bailed out by subsequent devaluation, the argument for fixed exchange rates has lost its cogency.

The belief that the facts of economic and political life demand a system which is *less* rigid than a system of *permanently* fixed rates was expressed in the Bretton Woods compromise which created the

adjustable-peg system. Since we have already seen that this system has the shortcoming of depriving the international payments system of its tautness, of leading to disequilibrating speculation, and of administering the needed adjustments shockwise rather than smoothly, we must look for a better compromise between discipline and freedom.

For this purpose we must first investigate a system of freely fluctuating exchange rates, the system which the experts at Bretton Woods refused even to consider. Much can be said for such a system. But even if theoretical considerations should lead us to the conclusion that a system of freely fluctuating exchange rates would be preferable to a system of fixed or adjustable rates, we might still have to settle for a compromise if freely fluctuating exchange rates are flatly rejected by central bankers. If the present attitude in the International Monetary Fund is indicative, a system with freely fluctuating exchange rates still meets with the same entirely negative response as at the time of Bretton Woods, in spite of the interesting fact that an ever increasing number of economists now favors some form of exchange-rate flexibility.¹⁹

The proponents of exchange-rate flexibility consider it unnatural that currency units of different nations should be tied to one another at fixed rates, e.g., through gold parities. The exchange rate is a link between two national price systems and should be expected to vary roughly with the ratio of change of domestic purchasing powers of the national currencies.²⁰ The exchange rate should be a market price. To fix this price when market conditions change is a violation of one of the most basic working principles of the market economy. Exchange-rate variations would tend to bring about balance-of-payments equilibrium, while fixed rates lead to disequilibrium when they differ from what the market rates would be under given demand and supply conditions. To correct this disequilibrium, interest rates must be raised in the deficit countries and lowered in the surplus countries.

The advocates of flexible exchange rates contend that the adjustment

¹⁹ For a listing of economists favoring a system of exchange-rate flexibility, see Fritz Machlup, *Plans for Reform of the International Monetary System*. Special Papers in International Economics, No. 3 (Princeton, N.J.: International Finance Section, Princeton University, March 1964), pp. 79-81.

²⁰ The Bullion Report stated as early as 1810: "In the event of the prices of commodities being raised in one country by an augmentation of its circulating medium, while no similar augmentation in the circulating medium of the neighboring country has led to a similar rise in prices, the currencies of the two countries will no longer continue to bear the same relative value to each other as before. The exchange will be computed between these two countries to the disadvantage of the former."

mechanism under fixed rates is indirect, slow, roundabout, and artificial. Indirect and slow, because a change of the exchange rate would have directly and instantly changed the prices of all commodities in terms of the other country's currency unit. Roundabout and artificial, because the system first *fixes* one strategic price, the rate of exchange, only to have to *alter* another and even more strategic price, the rate of interest, and through the rate of interest the whole price level of the country.

The advocates of exchange-rate flexibility want to release the rate of interest from the task of having to be primarily responsible for the country's balance of payments. This task may conflict with the desire to maintain a relatively low bank rate in order to achieve a high level of employment, or a high bank rate in order to combat domestic inflation.

Thus it is argued that flexible exchange rates furnish the authorities with better tools to carry out the assignment of maintaining both external and internal equilibrium.²¹

When fixed exchange rates are maintained, the monetary authority may not be able to choose the rate of interest best designed to reach a high level of employment. Nor can fiscal policy solve the dilemma that fixed exchange rates create. If fiscal policy is to include deficit spending, it is not at all sure that we can make fiscal policy responsible for internal, and monetary policy for external equilibrium. Why not use flexible exchange rates for maintenance of the external balance and both monetary and fiscal policy predominantly for domestic stability and full employment? Then we would not have to make the often abortive attempt of using monetary and fiscal policies at cross purposes.²²

²¹ Ragnar Nurkse defined internal equilibrium as "a level of national income such that there is neither general unemployment nor an inflationary tendency for prices to rise" and external equilibrium as "a balance of payments that maintains itself without the persistent need for monetary stopgaps." Ragnar Nurkse, "Domestic and International Equilibrium," in Seymour E. Harris (ed.), *The New Economics* (New York: Alfred A. Knopf, 1948), p. 272. It is obvious that perfect internal equilibrium, as defined by Nurkse, cannot be achieved in the real world of today. Perfect monetary stability (whatever that may mean) might be achievable only at the cost of some unemployment. In other words, the level of income that avoids general unemployment may easily differ from the level that avoids an inflationary tendency of prices to rise.

²² Egon Sohmen, however, goes too far when he suggests that the introduction of flexible rates would strengthen domestic monetary policies to such an extent that we could then dispense with fiscal policies. Sohmen's argument rules out all fiscal-policy conclusions that had to be drawn from Keynes' *General Theory* and applied to a *closed* economy. Egon Sohmen, *International Monetary Problems and*

As far as the danger of competitive exchange depreciation is concerned, the advocates of exchange-rate flexibility argue that the monetary authorities would not misuse their power even if they should intervene in the foreign-exchange market. Besides, competitive undervaluation is more likely to exist under fixed exchange rates. Surplus countries can always compensate for the domestic monetary expansion which would otherwise be the automatic result of official purchases of foreign exchange at the lower support point. But if the surplus country prevents a domestic monetary expansion, its currency remains undervalued and the balance-of-payments surplus continues to grow to the detriment of the deficit country, which now has to shoulder a double adjustment burden. An uninterrupted loss of reserves forces it into contraction. Competitive undervaluation, therefore, can be just bad as competitive depreciation.

If the representatives of surplus countries claim that they are forced to protect themselves against "imported inflation," the proponents of flexible rates answer that the embarrassing inflationary pressures would not have arisen had the surplus currency been permitted to appreciate. Again we see that a system of fixed exchange rates may lead to results which are detrimental to both internal and external equilibrium.

The case for flexibility is dangerously overstated if we argue that the freely fluctuating exchange rates would maintain external equilibrium *no matter what domestic policies the trading countries follow*.²³ Continuous inflationary expansion in a member country would lead to capital flight, to a steadily rising demand for foreign exchange, and to exchange depreciation at an accelerated rate. However, this is not an argument against exchange-rate flexibility in normal times and assuming a normal degree of harmonization of the economic policies of the members. Besides, we have seen already that many advocates of fixed exchange rates ask for a very high degree of freedom for domestic policies and, accordingly, for enormous amounts of international reserves. There are extremists in both camps.

* * * *

The contrast between fixed and flexible rates of exchange is greatest when we compare *rigidly* and *permanently* fixed with *freely* fluctuating

the Foreign Exchanges. Special Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963).

²³ "The single most potent objection to flexible rates is undoubtedly the argument that they might encourage undisciplined policies which could prove to be disruptive over the long run." Egon Sohmen, *op.cit.*, p. 8.

rates. In a compromise plan we can reduce the distance between these positions. Exchange rates need not be *rigidly* fixed; they can be permitted to vary within a certain range; and they need not be *permanently* fixed but can be subject to change under special circumstances. The exchange rates of the member currencies in the International Monetary Fund, for instance, are permitted to fluctuate moderately and can be changed under conditions of fundamental disequilibrium.²⁴ Similarly, exchange-rate flexibility need not mean freely fluctuating exchange rates. In a system with freely fluctuating exchange rates the national authorities would never intervene in the exchange markets and would never need, and never accumulate, any foreign-exchange reserves. If the monetary authorities are permitted to intervene in the foreign-exchange markets we would have a system of *managed* flexibility. The flexibility would be *limited* if the exchange rates were permitted to fluctuate only within a predetermined range, fluctuations beyond the limits of this range being prevented by compensating official sales and purchases of foreign exchange or gold. Within the limits the system could be managed or unmanaged.

We shall now turn to these compromise positions between rigidly and permanently fixed and freely fluctuating exchange rates. First, different possibilities will be listed; then, one version of the band proposal will be discussed in greater detail.

²⁴ *Articles of Agreement. International Monetary Fund* (Washington: United States Treasury, 1944), Art. IV, Sec. 3 and Sec. 5 (f).

II. The "Band" Proposal

Different Versions of the Proposal

We can arrange various proposals to deal with the international monetary system along a continuum of increasing flexibility (or diminishing rigidity), including different versions of the band proposal.

(1) One extreme is the setting of rigidly fixed parities which are not to be changed under any circumstances. No spread around the par value is permitted (the so-called gold points are abolished) and it is clearly understood and believed that the fixed parities will never need adjustment. This system would require either a maximum of international liquidity reserves or a maximum of international integration, or any viable combination of the two.

(2) The exchange rates can be rigidly fixed, but adjustments can be permitted. Again, the exchange rates may not move away from parity, but they may be adjusted once in a while when international cooperation or international liquidity reserves prove insufficient to permit maintenance of free convertibility at rigid rates. One could call this arrangement "step-ladder flexibility."

(3) The exchange rates are permitted to fluctuate within the so-called gold points; adjustments of parities, however, are ruled out. This was the case of the gold-standard mechanism. The spread between the gold points was equal to double the cost of transferring gold from one country to another.

(4) Small fluctuations around parity are combined with the possibility of parity or "peg" adjustments under special circumstances, as at present under the International Monetary Fund Agreement. The permitted spread is now the result of a prescribed maximum margin above and below par value for transactions in gold, and adjustments of the peg by more than 10 per cent are permitted only in cases of "fundamental disequilibrium."

(5) The band for permissible exchange-rate variations can be broadened by increasing the "prescribed margin," i.e., by raising the selling and lowering the purchase price of gold or foreign exchange. However, the parity itself is *not* to be changed and the monetary authorities must accordingly avoid fundamental disequilibria. The elasticity provided by the broadened band for exchange-rate variations replaces parity adjustments.

(6) The broadening of the band can be combined with parity adjustments. When exchange-rate variations within prescribed limits cannot achieve long-run equilibrium, i.e., when the exchange rates get "stuck" at the upper or lower support points, the parity, and with the parity the whole band, is moved. This is the system of the "movable band."²⁵

(7) Permissible exchange-rate variations within fixed support points, as in combinations (3) to (6), may be completely free in the sense that the monetary authorities do not buy or sell foreign exchange before the support points are reached, i.e., do not influence the exchange rates as long as they stay within the limits. The system implies, however, that the monetary authorities stand ready to maintain an "unlimited" supply at the upper support point and an "unlimited" demand at the lower support point.

(8) The monetary authorities do not only maintain perfectly elastic supply and demand conditions at the support points but feel free to influence the exchange rates at any time even within these limits through their buying and selling operations. The exchange market remains free from exchange control but not free in the sense of being exposed only to private market forces.

(9) The monetary authorities can either announce their support points or leave private speculation in the dark as to their intentions; they can announce official buying and selling prices closer to par within the official limits; or they can widen the band as earlier steps in this direction prove successful. Finally, they may influence the market in day-to-day transactions without the intention of maintaining predetermined limits.

(10) The opposite of the case of rigidly and permanently fixed exchange rates is the case of freely fluctuating rates without support points and without any attempt by monetary authorities to influence the rates. Since the authorities abstain completely from buying and selling operations in the foreign-exchange markets, they do not acquire or use foreign-exchange reserves. It would be wrong, however, to equate this system with one of excessively wide exchange-rate fluctuations. Close integration of national economic policies could lead to very stable exchange rates.

Our list could easily be lengthened, e.g., by applying certain com-

²⁵ It is better not to call it the system of the "adjustable band," because this term could as well, or better, refer to changes of the width of the band at stable parities—which would be a totally different proposition.

binations to the members of a group of countries in which close monetary integration is practiced and other combinations or versions to their relationships with other groups.

Since we can argue that the details of a system which operates with a broadened band should be worked out as we gain practical experience, there remains only one main choice concerning the various versions of the band proposal—we must decide whether we want to see in it a substitute for the adjustable-peg system or simply a new version of the latter, i.e., a “movable-band” system.

The present paper proposes that a broadened band should *replace* the adjustable peg.

Basic Principles and Operations

The proposal to broaden the band of permissible exchange-rate variations, but to maintain fixed parities, seeks to retain some of the discipline which can be expected of a system of permanently fixed exchange rates, and some of the greater freedom and the smoother adjustment process which can be secured by flexible exchange rates. Limited exchange-rate variations are to be substituted for discontinuous alterations of the peg, because the latter tend to soften the discipline of fixed rates and to replace smooth adjustments of market prices by long overdue and abrupt changes, which in turn are the breeding ground for the worst form of speculation.

The basic idea is old and simple. The gold or support points are pushed apart by raising the selling and by lowering the purchase price of gold (or of an international monetary unit such as *bancor*). At the support points demand and supply become perfectly elastic, because the monetary authority of each country stands ready to buy and sell gold, or foreign exchange, in unlimited amounts. The exchange rate cannot rise above or fall below these limits. When the limits are reached, foreign exchange or gold reserves are decreased or increased until external equilibrium is reestablished.

In the old gold-standard mechanism with rigid gold parities, the width of the band was determined by the cost of transporting gold from one country to another. Even at rigidly fixed parities, therefore, there existed a narrow ribbon within which exchange rates were permitted to move. Where buying and selling prices of gold differed, the double transportation cost, added to this margin, would determine the gold points.

In what follows we assume that the band is the same, irrespective of the cost of gold transportation. We agree with H. L. Puxley's statement that it would be "anomalous that a smaller fluctuation in Anglo-French exchange rates should cause gold to flow between the two countries than would be necessary to prompt a movement of gold between either of the countries and the United States" simply because the transportation cost of gold in one case is smaller than in the other. "If . . . the larger interval between the gold points of the sterling-dollar exchange at the same time affords useful protection to the gold reserves of both England and the United States, there is no logical reason why the gold reserves of France and England should be denied similar protection with respect to each other." Puxley proposed a broadened band in which the transportation charges have become uniform.²⁶ Technically this could be achieved easily, for instance, by the practical elimination of transportation charges as price-determining factors through the mutual holding of reserve deposits of gold (earmarking).

Whether central banks or other government agencies should influence exchange rates within the band is an open question. To leave exchange-rate variations entirely to free market forces would have the advantage of simplicity and automaticity. The monetary authorities would abstain from sales or purchases until the support points were reached. At these points, however, the transactions of the public would be met unflinchingly by compensating official transactions.

It is probable that exchange-rate variations without government intervention would exert an equilibrating influence and that the system would enjoy a built-in stabilizer. However, as long as we do not know whether the band should permit small or large exchange-rate variations, we cannot argue too convincingly that, say, a 5-per-cent margin would be just right, both for the encouragement of equilibrating (and the prevention of disequilibrating) capital movements and also for the speedy adjustment of the trade balance. In the latter case we know too little about price elasticities of demand and supply, and in the former we deal with psychological attitudes which are not always predictable. Even though we can show that exchange-rate variations within the band will work in the right direction, we cannot be sure that the dosage will always be best.

Most of the band proposals, therefore, advocate not only *limited*

²⁶ H. L. Puxley, *A Critique of the Gold Standard* (New York: Harper & Brothers, Publishers, 1935), pp. 200-201.

but also *managed* flexibility. The exchange-rate variations inside the band do not just become another price fluctuation, they may become a policy instrument in the hands of the monetary authority. Exchange-rate variations can be considered as strategic price changes just like bank-rate adjustments. Exchange-rate variations, for instance, can be used to compensate for existing interest-rate differentials and thus regulate the international flow of short-term private capital. "It is this distance," wrote Keynes, "which protects the money-market of one country from being upset by every puff of wind which blows in the money-markets of other countries."²⁷

An important practical reason for *managed* limited flexibility is obvious. Central bankers will accept the proposal more readily if it is viewed by them as opportunity to add an important policy instrument to the arsenal of the monetary authority. In this context it is very important to realize that the *influencing* of prices by government agencies is not open to the same criticism to which price *fixing* is exposed.

The Gradual Approach

The widening of the band could be carried out in successive stages as central bankers gain experience and confidence in their ability to cooperate successfully. Similarly, foreign traders, investors, and exchange dealers will learn to operate under more flexible conditions. It will become apparent that exchange-rate variations, within firm limits, will encourage equilibrating and discourage disequilibrating capital movements. Central bankers will appreciate the availability of a new monetary instrument, gain confidence in its use, and develop courage to apply it more boldly. Eventually they may even find that market fluctuations alone, uninfluenced by government transactions, can establish external equilibrium. In this case, the authorities may leave the market alone after having set the limits. Foreign traders will discover that hedging will offer the needed protection against exchange-rate fluctuations at relatively insignificant cost, and all concerned will see that exchange-rate variations do exert an equilibrating effect on the trade balance, an effect which will prevent them, in turn, from becoming excessive.

It would be presumptuous to determine in advance once and for all

²⁷ John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), p. 325.

the correct width of the band or the proper course of government actions within the band.²⁸ Only experience will show. A modest widening of the presently permitted span of 2 per cent to, say, 3 or 4 per cent, and then perhaps further as it is deemed desirable, recommends itself as a safe approach to greater exchange-rate flexibility. This approach could be combined with a *de facto* and, eventually, a *de jure* abolition of the adjustable-peg system, which would then no longer be needed.

We must be fully aware of the fact that the widening of the band by degrees but around a *fixed* parity has nothing in common with peg adjustments. The latter cause disequilibrating capital movements when they are anticipated, and shocks to the economy when they are carried out. A widening of the band, by contrast, need have no disturbing effects unless it were very badly timed and could be interpreted as a disguised peg adjustment. The two must be clearly kept apart.

It may happen, of course, that the flexibility provided by the broadened band will not suffice and that the parity, and with it the whole band, must be changed. If such cases were very rare exceptions, they need not ruin the system and the adjustment could possibly be handled by a temporary imposition of exchange controls. But frequent shifts of the whole band, i.e., a "movable-band" system would not be conducive to the gradual introduction of a genuine system of flexibility.

Once the system of limited exchange-rate variations has been operated successfully for some time, it might be possible to drop both the limits and the management within the limits, with the rates of exchange nevertheless staying reasonably stable. Here, as in other national payments systems, success will depend on the degree of integration of national economic policies and on the contribution which greater exchange-rate flexibility itself can make to the harmonization of the member countries' monetary policies.

Since all policies concerning exchange rates affect two currency units, it is logical to assume that the broadening of the band would

²⁸ Egon Sohmen, one of the most consistent advocates of a system of freely fluctuating exchange rates, writes: "Before a country embarks upon an experiment with fluctuating rates, it is of the utmost importance that its government and its central bankers appreciate both the increased power of the tool in their hands and the need to use it more often and more unhesitatingly." *International Monetary Problems and the Foreign Exchanges*. Special Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 75. Would it not be wise then to introduce a system of freely fluctuating exchanges if and when a system with wider but still limited exchange-rate variations has succeeded?

be subject to international cooperation and control.²⁹ To avoid inconsistency between exchange rates and to prevent national authorities from working at cross purposes, a system with wider exchange-rate variations should be operated through some international arrangement inside or outside the International Monetary Fund.³⁰

This international cooperation might seem to pose grave problems and perhaps even revive the danger of competitive exchange depreciation. But if it is understood that the system serves to encourage equilibrating short-term capital movements, to eliminate disequilibrating flows from deficit to surplus countries (which are bad for *both*), and to give all participating countries greater freedom in the use of their monetary instruments, then different countries will be interested in the *same* exchange-rate variations. We underestimate the great progress that has already been made in international monetary cooperation if we fear that the "multilateral surveillance"³¹ that has already worked well in connection with bilateral financing and liquidity creation, could not undertake the coordination of national operations in the foreign-exchange markets.

It goes without saying that a cooperative system of the type proposed can work only between countries whose economies and economic policies are fairly similar. How much the national policies may be permitted to diverge would be determined by the width of the band and the availability of international liquidity reserves. If the national economic policies differ so much that the effect of interest differentials can no longer be neutralized by exchange-rate variations inside the band, the proposed system would deteriorate into a "movable-band" system.

²⁹ "Even moderate purchases and sales of foreign exchange by independently acting monetary authorities of different countries are apt to lead to mutually incompatible exchange rates between the same currencies. Unless the monetary authorities are in continuous accord with one another—agreeing on the supposedly free market rate, which they must act in concert to obtain or maintain—their interventions in the foreign-exchange markets will result in inconsistent rates, providing juicy profits to exchange arbitrageurs." Fritz Machlup, *Plans for Reform of the International Monetary System*. Special Papers in International Economics, No. 3 (Princeton, N.J.: International Finance Section, Princeton University, March 1964), p. 74.

³⁰ If the old gold mechanism were to serve as model, we might, for instance, want to manage the system through a gold pool.

³¹ This term is used in the Annex to the Ministerial Statement of the Group of Ten of August 10, 1964. One of the reasons for strengthening the review and appraisal process of multilateral surveillance "would be to give the monetary authorities of countries participating in the Arrangements a more comprehensive and up-to-date view of major trends and afford them a better basis for strengthening their policy cooperation in the international monetary sphere."

We cannot expect that *all* members of the international payments system will follow reasonably similar domestic policies, but within a group of countries the harmonization of economic policies may have advanced quite far. Such a group might maintain balance-of-payments equilibrium *within* the group by relatively small exchange-rate variations, while *between* groups a larger flexibility of rates may be needed. Again, it is desirable to test the system at first in the most promising environment. The introduction of the system, therefore, should not only be gradual over time but also gradual in a regional sense.

The Proposal and the Fund Agreement

Introduction of a widened band would not require any decisive change in the Articles of Agreement of the International Monetary Fund. Only Article IV would need some minor revision. Section 3 (1) would have to be changed, perhaps repeatedly, as we desired to broaden the band. Such repeated changes would not be exposed to the dangerous consequences of repeated parity changes under Article IV, Section 5 (f), which deals with parity changes in consequence of a fundamental disequilibrium. The crucial difference lies in the fact that successive decisions to broaden or to narrow the band around the *same* parity would be innocuous as far as destabilizing speculation is concerned, while successive changes of the parity itself would provoke capital-flight movements.

Ideally, a well-functioning system of flexible exchange rates should make it possible to abolish the adjustable-peg system, i.e., to delete Article IV, Section 5 (f) of the Fund Agreement altogether or at least to characterize changes in par values as events of a cataclysmic nature not to be found normally in a system with currency convertibility.³²

Since the proposal does not deal with changes in par values but only with the margin above and below par value, Article IV, Section 8 about the maintenance of the gold value of the Fund's assets would not apply.

³² As rare and disturbing events, changes of par values might be combined with a temporary imposition of exchange controls. Permission to use exchange controls could be granted similar to the permissions according to Articles VI-1, VII-3, and XIV-2.

III. History of the Proposal: Before World War II

Origin and Early Techniques

It will be noticed that the proposal seeks to *broaden* and not *create* limits for permissible exchange-rate variations. The possibility for minor variations existed under the old gold-standard mechanism in the form of those small deviations from gold parity which were determined by the cost of shipping gold from country to country. Buyers of foreign exchange were not willing to pay a price above the upper or gold-export point, because they could always procure foreign exchange by the shipment of gold, which they could buy at a fixed price and in unlimited amounts at home and sell at a fixed price and in unlimited amounts abroad. Similarly, the sellers of foreign exchange would not accept a price lower than the gold-import point, at which it was possible to transfer claims on foreign countries via gold shipments.

Restoration of balance-of-payments equilibrium depended under the gold mechanism on exchange-rate variations and on changes in interest rates. Exchange-rate changes would occur automatically with varying demand and supply conditions in the foreign-exchange market. These small variations, which could not exceed the spread between the gold points, would lead to equilibrating capital movements. The depreciation of a currency would stimulate foreign demand for the currency in expectation of the certainty of a rebound. Furthermore, even small variations of exchange rates would have a slight effect on international trade by stimulating the deficit country's exports and toning down its imports. In brief, *within* the gold points, a system of flexible exchange rates was at work.

Often, however, these reactions were not considered strong or fast enough to bring about the desired elimination of a balance-of-payments disequilibrium. Exchange-rate variations, therefore, were aided by changes in short-term rates of interest. The deficit country would raise, and the surplus country would lower, the bank rate. These interest-rate differentials would make equilibrating private capital movements even more attractive. An inflow of capital would lead to temporary relief in the external balance and would give the fundamental adjustment mechanism time to work: the domestic monetary contrac-

tion in the deficit country, and the domestic monetary expansion in the surplus country, would lead via price (and income) changes back to external equilibrium. Gold might never have to flow under this system if the monetary authorities were alert.

We see that the principles of fixity and flexibility were in practice always combined and that equilibrating capital movements took care of temporary disequilibria, and of the additional supply of foreign exchange that was needed for the period during which the more fundamental adjustments took effect.

Proposals and attempts to widen the distance between the gold points in order to increase the flexibility of the adjustment mechanism can be found rather early. Jacob Viner notes that Robert Torrens recommended in 1819 that "if a return were made to the gold standard, it would be desirable that the range between the gold points should not be too small." Torrens opposed Ricardo's plan of substituting bullion for coin because coin was "a less eligible article for export" and permitted a wider margin between gold points.³³

Viner lists quite a few devices that have been proposed and used to widen the distance between the gold points such as "seigniorage charges, premiums of gold for export, different buying and selling prices for gold at the Central Bank, generous tolerance for underweight in the internal specie circulation, differential buying and selling prices for the gold of the particular degrees of fineness most in supply or demand abroad and other similar devices."³⁴

For more recent times Arthur I. Bloomfield has shown how various central banks tried to manipulate the gold points to influence "the international movement of short-term funds and/or of gold in the desired directions. These devices were usually undertaken as short-run alternatives to discount rate changes or as supplement to them, and in some cases simply to offset the effect of similar measures being undertaken by other central banks."³⁵

In these attempts to broaden the limits of exchange-rate variations the techniques are of minor interest. Important is the fact that central bankers had the desire to widen the margin at a time when price systems were still flexible and rigidity of exchange rates much less problematic than it is today.

³³ Jacob Viner, *Studies in the Theory of International Trade* (New York: Harper and Brothers, Publishers, 1937), pp. 206-207.

³⁴ *Ibid.*, p. 378.

³⁵ Arthur I. Bloomfield, *Monetary Policy under the International Gold Standard: 1880-1914* (Federal Reserve Bank of New York, October 1959), p. 52.

Von Mises' Criticism of the Gold-Premium Policy

Ludwig von Mises criticized the use of the techniques indicated above as attempts to permit deficit countries to carry on "cheap-money" policies at a time when credit contraction would have been the proper policy to reestablish external equilibrium.³⁶ Von Mises felt that a gold-premium policy could delay the needed adjustment of domestic interest rates to increased foreign rates only for a very short time. Conceivably the gold-premium policy could be of some minor use when the situation promised to reverse itself very soon. He admitted that the policy "may sometimes have avoided raising the discount rate when it would otherwise have been necessary to do so for a short time."³⁷

He emphasized the interdependence of interest rates between different countries, pointing out that the mobility of capital goods is so great that it leads to the formation of a homogeneous capital market and that "the net rate of interest is no longer determined according to national, but according to international, considerations. Its level is settled, not by the natural rate of interest of the country, but by the natural rate of interest *anywhere*."³⁸ Adjustments to the world rate could not be stopped by a minor device such as the gold-premium policy. Nor would this be in the interests of those who propose to delay or hinder interest arbitrage. For the rate of interest could be kept down effectively "only by a suppression of the export of capital and complete exclusion of the country from international trade."³⁹

Von Mises did not care to distinguish between capital movements and commodity movements and considered it false to regard interest arbitrage as an "illegitimate" demand for gold in contrast with a demand resulting from the trade balance. "The idea on which this distinction is obviously based," he wrote, "is that trade in commodities and dealings in capital are two perfectly distinct and independent

³⁶ Ludwig von Mises, *The Theory of Money and Credit* (New York: Harcourt, Brace & Co. Inc., 1935), chapter VI. Von Mises discussed the gold-premium policy of the Bank of France but saw no essential difference between this policy and, e.g., the method of issuing, for export purposes, worn gold coin of inferior value, as practiced by Great Britain and Germany. The French policy rested on legal provisions which permitted the Bank of France to redeem its notes either in gold or in silver five-franc pieces. When gold was demanded for the "illegitimate" purpose of speculating on the difference between interest rates at home and abroad, gold was handed over only at an additional charge.

³⁷ *Ibid.*, p. 380.

³⁸ *Ibid.*, p. 374.

³⁹ *Ibid.*, p. 377.

branches of economic activity and that it would be possible to restrict the one without affecting the other.”⁴⁰

We shall see presently that von Mises’ attitude was diametrically opposed to John Maynard Keynes’ ideas on the subject.

Keynes on Gold Points

The most elaborate proposal for establishing “a fair distance between the gold points” was made by John Maynard Keynes in 1930 in *A Treatise on Money* and in 1933 in *The Means to Prosperity*.⁴¹ Keynes argued that “the greater the distance between the gold points, the less sensitive to short-period external changes a country’s rate of foreign lending will be.”⁴² An increased margin would allow for a reasonable independence of bank-rate and credit policy to suit differing national circumstances “though there would be nothing to prevent a Central Bank from maintaining the gold equivalent of its national money within narrower limits in normal times.”⁴³

In contradistinction to von Mises, Keynes argued against rigidly fixed exchange rates and a complete integration of credit markets because he wanted to protect national economic policies against too much exposure to outside forces. “Circumstances may arise,” he wrote, “in which, if a country’s rate of interest is fixed for it by outside circumstances, it is impracticable for it to reach investment equilibrium at home. This will happen if its foreign balance is inelastic, and if, at the same time, it is unable to absorb the whole of its savings in new investment at the world rate of interest. . . . There are, moreover, all sorts of other reasons why the day-to-day preservation of local investment equilibrium may require some departure of the local rate of interest from the international rate.”⁴⁴

We have already seen that rigidly fixed exchange rates must lead to changes in the trading countries’ interest rates. To argue for some freedom of domestic economic policy means to reject *rigidly* fixed exchange rates. Only under the unrealistic assumption that prices and wages are instantly adjustable could international payments equilibrium be combined with rigidly fixed exchange rates. A realistic appraisal of

⁴⁰ *Ibid.*, p. 385.

⁴¹ John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), chapter 36; *The Means to Prosperity* (New York: Harcourt, Brace and Company, 1933), pp. 32-33.

⁴² Keynes, *Treatise*, Vol. II, p. 320.

⁴³ Keynes, *Means to Prosperity*, p. 33.

⁴⁴ *Treatise*, Vol. II, pp. 303-304.

the slowness of the adjustments in prices, wages, production and trade is the crux of the matter.

Keynes pointed out that the main danger of a highly sensitive flow of capital under rigid exchange rates lies in "a high degree of short-period mobility of international lending, combined with a low degree of short-period mobility of international trade."⁴⁵ He considered it "impracticable to bring about a change in the foreign balance great enough to balance the change in foreign lending which even a small stimulus may provoke. . . . In this way adherence to an international standard tends to limit unduly the power of a Central Bank to deal with its own domestic situation so as to maintain internal stability and the optimum of employment."⁴⁶

To gain some independence for national economic policy, Keynes proposed two types of remedies: "(1) those whereby the authorities *offset* the action of the market, and (2) those whereby the authorities *influence* the action of the market."⁴⁷

To *offset* the action of the market a central bank needs command over large foreign-exchange or gold reserves. Letting the reserves fluctuate widely, it can prevent changes in foreign lending from having undesirable effects on domestic rates of interest. This proposal foreshadows the *Keynes Plan* of 1943. In 1930 Keynes suggested reduction of domestic gold-reserve requirements, holding of buffer reserves of gold, holding of large liquid balances in foreign centers, arranging of overdraft facilities between central banks and, finally, "borrowing and lending arrangements between Central Banks and a Supernational Bank."⁴⁸

The authorities can *influence* the market to regulate the rate of net foreign lending. They can, for instance, try to adapt the organization of a country's security markets to its normal capacity for foreign lending; they can use discriminatory taxation; control issues of foreign securities; and, finally, control the rate of short-term foreign lending.⁴⁹

Keynes considered large movements between long-term and short-term assets and between individual currencies (and currencies and gold) as dangerous. He argued that these movements—unless they

⁴⁵ *Ibid.*, p. 309. We note Keynes' complete rejection of von Mises' assumption of the practical identity of capital movements and commodity movements, and of money capital and capital goods.

⁴⁶ *Ibid.*, p. 309.

⁴⁷ *Ibid.*, p. 310.

⁴⁸ *Ibid.*, pp. 310-311. It should be noted how much of the gist of our present discussions and attempted solutions was already contained in Keynes' suggestions of 1930.

⁴⁹ *Ibid.*, p. 315.

can be offset—should be kept in check through appropriate changes in interest rates. The problem, however, was that the emerging rates of interest would not necessarily be the rates best suited to maintain both international and domestic equilibrium.

The problem could be resolved if it were possible to use two rates of interest, one of which would establish internal and the other external equilibrium. Keynes did not believe that such a policy could succeed in practice. He pointed out that

credit is like water;—whilst it may be used for a multiplicity of purposes, it is in itself undifferentiated, can drip through crannies, and will remorselessly seek its own level over the whole field unless the parts of the field are rendered uncompromisingly watertight,—which in the case of credit is scarcely possible.⁵⁰

At this crucial point in his argument Keynes made the proposal that the margin between the gold points should be widened. This arrangement would permit “a substantial inequality to exist between the rates of interest obtainable in two different currencies respectively if the rate of exchange existing at the moment cannot be relied on to last for more than a short period.”⁵¹

Accordingly, Keynes suggested

that the difference between a Central Bank's obligatory buying and selling prices of gold should be made somewhat greater than hitherto, say 2 per cent, so that there would be at least this difference between the gold points irrespective of the actual costs of transporting gold (double the amount of which would have to be added on to the 2 per cent to give the difference between the gold points). But the Central Bank would be free at any time, if it wished to encourage the movement of gold inwards or outwards, to quote closer prices within the legal limits. Further, a Central Bank should be in a position to control, when necessary, within the limits set by the gold points and the relative rates of interest at home and abroad, the premium or discount of the forward exchange on the spot exchange; whereby short-period interest-rates at home could stand *temporarily* in such relation (within limits) to similar rates abroad as the Central Bank might deem advisable.⁵²

⁵⁰ *Ibid.*, p. 319.

⁵¹ *Ibid.*, pp. 323-324.

⁵² *Ibid.*, pp. 325-326. See also *The Means to Prosperity*, p. 32, where Keynes proposed a difference of not more than 5 per cent between the buying and selling points for gold.

We must distinguish Keynes' proposal clearly from some older arguments for and against a widened band. In the standard picture of the working of the gold mechanism, fluctuations of exchange rates between the gold points fulfilled the important task of leading to *equilibrating* short-term capital movements. Exchange-rate variations *supported* interest-rate differentials in moving private capital to the country in need of an additional supply of foreign exchange. Short-term capital movements were considered advantageous because they would give time to carry through whatever domestic measures were needed to reestablish external equilibrium without detrimental effects for internal equilibrium or for the world economy. The flow of private capital, therefore, was to have the same cushioning effect for which Keynes demanded large reserves of foreign exchange. As a matter of fact, these capital movements were the gold mechanism's substitute for international reserves other than gold.

These capital movements have been attacked with the argument that a deficit country should not rely too much on foreign borrowing because the inflow of foreign short-term capital would tend to interfere with basic long-term adjustments.⁵³

To eliminate these "equilibrating" capital movements that are caused by exchange-rate variations we would have to establish rigid gold parities, i.e., abolish the gold points altogether. Keynes dealt with disequilibrating capital movements which are due to interest-rate differentials caused by an attempt to achieve domestic equilibrium. To illustrate his case he used the following example:

In the autumn of 1928 local conditions in the United States convinced the Federal Reserve Board that the short-period interest

⁵³ "If the automatic gold standard is supplemented by discount rate policy, a rise in the rate designed to curb internal expansion may attract short-time funds from abroad. Difficulties of this kind were fairly common in the twenties. With capital the most volatile item in the balance of payments, it is apt to dominate and to nullify any corrective effects which might otherwise result from the gold standard process of adjustment." John H. Williams, *Postwar Monetary Plans and Other Essays* (New York: Alfred A. Knopf, 1945), p. 205. Williams did not mean to criticize Keynes' argument. R. G. Hawtrey, however, misinterprets Keynes, when he believes that Keynes wanted to exclude foreign capital because it would delay the effect of credit measures designed to reestablish external equilibrium, and that "the progressive accumulation of short-term indebtedness becomes itself an independent threat to equilibrium." R. G. Hawtrey, *The Art of Central Banking* (London: Longmans, Green and Co., 1952), p. 413. Keynes was worried about capital movements which would interfere with internal (not external) equilibrium. He had no intention of establishing the gold mechanism at rigidly fixed rates, with all the harshness which an elimination of equilibrating capital movements would have implied.

rate should be raised in the interests of business stability; but local conditions in Great Britain were of a precisely opposite character, and the Bank of England was anxious to keep money as cheap as possible. The Federal Reserve Board did not desire that its high rates should attract gold from Great Britain; for this, if it occurred, would have tended to defeat its efforts. Nor did the Bank of England desire to impose high rates in Great Britain—to which it might be driven—in order to prevent its gold from flowing out. Such a situation could be handled by the above plan. The Federal Reserve Banks would reduce their buying price of gold to a figure nearer to their legal minimum, whilst the Bank of England would raise its selling price for gold nearer to its legal maximum.⁵⁴

Keynes' example makes no reference to the original balance-of-payments position of the two countries, though it does make some difference which of the two countries we assume to be in surplus or in deficit in its external balance. If the low-interest country (Great Britain) is not only having to cope with depression at home but is simultaneously suffering from a balance-of-payments deficit, an out-flow of capital will accentuate its difficulties and, simultaneously, compound the inflationary pressures in the high-interest surplus country (the United States).

If a rise of the price of the surplus country's money unit (in terms of the deficit country's currency) can stop this destabilizing flow of private capital from the deficit to the surplus country, the effect will be advantageous in terms of both internal and external equilibrium. If a deficit country suffering from depression tries to boost its exports and to lower its imports through contractionist monetary policies, i.e., if it *raises* its bank rate, it accentuates the depression that already paralyzes its industries. Yet, if it *lowers* the bank rate, its balance-of-payments position is made worse through capital export. If the rate of exchange were permitted to fluctuate within certain limits, the price of the surplus country's money unit would rise in terms of the deficit country's currency. Interest-rate differentials and exchange-rate variations would *not* pull in the same direction. The inducement to gain from higher interest rates would be counterbalanced by a loss in the related foreign-exchange transactions.

Not so long ago many economists would have challenged the assumption that a country in depression would suffer from a balance-of-

⁵⁴ Keynes, *Treatise*, Vol. II, p. 326.

payments deficit. With falling employment and income a country was expected to enjoy a balance-of-payments surplus. In this situation, a capital flow from the low-interest depression country to the high-interest high-employment country would not create balance-of-payments problems. The export of capital might lead to expanding commodity exports and increasing employment. Besides, exchange rates would follow the classical pattern and would rather support than hinder the capital flow. And since the country in depression could *create* credit, the outflow of capital need not raise its interest rates.

Modern experience has shown, however, that international payments deficit and domestic depression can easily coincide. This combination is not unusual if we can assume that unemployment and falling national income may go together with price inflation and with falling exports.

Keynes pointed out that *moderate* fluctuations of exchange rates would not hinder foreign trade since anyone could cover himself satisfactorily in a free and reliable market in forward exchanges.⁵⁵ Nor would long-term lending suffer. Even a 10-per cent spread between gold points would not be very serious.⁵⁶ "But in the case of a short-period loan the exact cost of paying off the loan at maturity may have a decisive effect on the total net cost of the loan reckoned *per annum*. This leads us to the heart of our argument."⁵⁷

Keynes then repeats the argument for a widened band once more in these words:

It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, whilst the remaining elements of the economic complex remain exceedingly rigid. If it were as easy to put wages up and down as it is to put bank-rate up and down, well and good. But this is not the actual situation. A change in the international financial conditions or in the wind and weather of speculative sentiment may alter the volume of foreign lending, if nothing is done to counteract it, by tens of millions in a few

⁵⁵ *Ibid.*, p. 333.

⁵⁶ "Suppose, for example, that the limits to the fluctuation of exchange has been fixed at 5 per cent on either side of par, then a 5 per cent loan in terms of the lender's money remitted at the par of exchange may cost in future years anything between 4% and 5% per cent interest, and when it is paid off the redemption may cost anything between 95 and 105, in terms of the borrower's money. In the case of a long-period loan these possibilities are not very serious . . ." *Ibid.*, p. 334.

⁵⁷ *Ibid.*, p. 334.

weeks. Yet there is no possibility of rapidly altering the balance of imports and exports to correspond.⁵⁸

These conclusions could have led Keynes to advocate a system of freely fluctuating exchange rates and they did—at least in theory. He considered as ideal “the management of a national currency on progressive lines . . . freed from the inconvenient and sometimes dangerous obligation of being tied to an unmanaged international system; . . . the evolution of independent national systems with fluctuating exchange rates . . . (and) . . . the linking up of these again into a managed international system.”⁵⁹

But he accepted as a *fait accompli* an international standard and a quasi-fixed exchange rate and suggested that “the best practical objective might be the management of the value of gold by a Supernational Authority, with a number of national systems clustering around it, each with a discretion to vary the value of its local money in terms of gold within a range of (say) 2 per cent.”⁶⁰ Thus he took in 1930 roughly the position of those who today argue for unlimited exchange-rate flexibility but are willing to compromise and to accept as second-best solution a system of limited flexibility.

Keynes' proposal to widen the limits for exchange-rate variations was incorporated into the International Monetary Fund Agreement (Art. IV, Sec. 3) though it had not found a place in his own Clearing Union Plan. He discarded widened gold points in favor of the more drastic proposal of frequent peg adjustments. This proposal has already been criticized.⁶¹

Expert Opinions in 1936

A Joint Committee of the Carnegie Endowment and the International Chamber of Commerce, investigating the problem of monetary stabilization in 1936, asked a group of experts, among other questions, whether we “should accept the view that wider ‘gold-points’ will enable a restoration of the stability in exchange.”⁶² The concluding report

⁵⁸ *Ibid.*, p. 336.

⁵⁹ *Ibid.*, p. 338. In one passage in his *General Theory*, in which he made a fleeting remark about an “open system,” Keynes assumed “that equilibrium with the rest of the world can be secured by means of fluctuating exchange rates.” *The General Theory of Employment, Interest, and Money* (London: Macmillan and Co., 1936), p. 270.

⁶⁰ Keynes, *Treatise*, Vol. II, p. 338. ⁶¹ See above, p. 4.

⁶² Joint Committee: Carnegie Endowment and International Chamber of Commerce. Separate Memoranda on *The Improvements of Commercial Relations be-*

stated that the experts could not agree on "such a fundamental question" as "the artificial widening of the gold-points with a view to avoiding too frequent movements of specie and strengthening the independence of local money and capital markets."⁶³

All the experts rejected the proposal to widen the gold points if it was put forward as a sufficient means for the "restoration of stability in exchanges." This attitude was not surprising, for nobody has ever suggested the band proposal as a panacea. All the experts found something to say for the proposal, however, even including von Mises,⁶⁴ who saw in wider gold points a closer approach to stability—if one compares this system with a system of boundlessly fluctuating parities. But he thought that wider gold points would not make the restoration of stability easier to attain because the central bank would have to follow exactly the same policy as under the orthodox gold standard once the upper gold point was reached.

T. E. Gregory saw in the proposal to widen the gold points "a minor technical device intended to reconcile the technical exigencies of the exchange position with the desirability of not disturbing internal conditions for the sake of merely temporary external disturbances."⁶⁵ But he also held that "if the rates of exchange can swing through a wider arc, powerful reinforcing factors can enter into operation" so that "remedial measures can be postponed for a rather longer period of time" and "greater opportunity is given for 'self-correction' of the exchanges."⁶⁶ In other words, the tide may turn before the support points are reached and serious action is called for. Maintenance of larger reserves would have the same effect, however.

Gregory's attitude is somewhat inconsistent in relegating the band proposal to a minor technical position while admitting, at the same time, that larger exchange-rate variations may be a powerful factor.

Von Mises and Gregory approached the question coming, as it were, from the gold-standard side, while Henderson, Mlynarski, and Hammarskjöld answered it in the conviction that greater freedom of domestic policies for internal equilibrium was essential.

D. H. Henderson admitted that "if the margin were of the magnitude of 10 per cent, the fall of the exchanges of a country towards gold-export point would supply a powerful check on any adverse capital

tween Nations and The Problem of Monetary Stabilization (Paris, June 1936), p. 174.

⁶³ *Ibid.*, p. 414.

⁶⁵ *Ibid.*, p. 190.

⁶⁴ *Ibid.*, pp. 170-177.

⁶⁶ *Ibid.*, p. 188.

movements, since those withdrawing or exporting money from the country would incur thereby a substantial exchange loss."⁶⁷ Free variations between such wide limits, however, would be disturbing to trade. "With a much narrower limit," on the other hand, "it would become doubtful whether the prospect of a comparatively trifling exchange loss would provide a sufficient safeguard against the possibility of large-scale capital movements."⁶⁸ Instead, Henderson proposed what amounted to the adjustable-peg system, viz., the freedom to alter the parities previously established "without being exposed to any imputation of bad faith."⁶⁹

Feliks Mlynarski supported Keynes' suggestion that "the future gold standard should adopt a wider margin than heretofore between gold-points in order to check the disturbing influence of capital movements on gold movements."⁷⁰

Dag Hammarskjöld expressed the opinion that the main question was not whether exchange rates should be fixed or alterable but only whether alterations were to be the result of financial crises or were to be "effected according to fixed rules and acknowledged as the perfectly natural results of changes in economic conditions that they are."⁷¹

His proposals amounted to a combination of a widening of the gold points and peg adjustments; in other words, to what one can call the "movable-band" system. Foreshadowing the Brookings Institution Report of 1963, he suggested that we should distinguish between different groups of countries, and permit wider and more frequent variations of exchange rates (obviously meaning a wider band and more frequent parity adjustments) *between* rather than *within* groups. He urged international cooperation but doubted the wisdom of using universal agreements and single-formula solutions, and favored the slower and less formal methods of cooperation until the time was ripe for more definitive moves.

⁶⁷ *Ibid.*, p. 167.

⁷⁰ *Ibid.*, p. 337.

⁶⁸ *Ibid.*, p. 167.

⁷¹ *Ibid.*, p. 385.

⁶⁹ *Ibid.*, p. 167.

IV. History of the Proposal: Recent Suggestions

Recent Proposals and Discussions

The proposal to broaden the limits of permissible exchange-rate variations has found support in recent debates on the international payments system and the United States' balance-of-payments problem. These discussions have remained academic, however. Central bankers and government officials still shy away from the mere mention of greater exchange-rate flexibility;⁷² and those economists who favor flexible rates often ask for more freedom than a mere broadening of the band would permit. The discussions, therefore, still tended to contrast freely fluctuating with fixed or pegged exchange rates. Nevertheless, there are indications that an increasing number of economists are willing to compromise and to accept a wider band, at least as a second-best proposal.

The band proposal achieved a modest victory when the Report of the Joint Economic Committee on *The United States Balance of Payments*⁷³ listed it as one of nine recommendations. True, it did not recommend immediate acceptance, but only that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange-rate variations." Pointing out that the present limits under the Fund Agreement are 1 per cent on either side of parity and that, in practice,⁷⁴ the spread is 1.5 per cent between the upper and lower support points

⁷² An example is the reaction of Frederick H. Klopstock to Representative Reuss' question as to what he thought of the suggestion "for vitiating the magnetic effect of interest rate differentials by widening the gold points." Klopstock's answer was: "Well, I have not studied this particular problem in great detail, but instinctively it does have very little appeal to me, I would say." *Outlook for United States Balance of Payments*. Hearings before the Subcommittee on International Exchange and Payments, Joint Economic Committee, 87th Congress, 2d Session, December 12, 13, and 14, 1962 (Washington, 1963), p. 142. The Ministerial Statement of the Group of Ten of August, 1964 says: "In reviewing the functioning of the international monetary system, the Ministers and Governors reaffirmed their conviction that a structure based, as the present is, on fixed exchange rates and the established price of gold, has proved its value as a foundation on which to build for the future."

⁷³ Report No. 965, Senate, 88th Congress, 2d Session, March 19, 1964, p. 18.

⁷⁴ The signatories of the European Monetary Agreement set the limits at 0.75 per cent on either side of parity.

The Committee concludes that a broadening of these limits would have several advantages.

(a) It would permit the monetary authorities greater freedom to pursue independent monetary policies without providing incentives for short-term capital movements; the authorities would have greater scope for short-term intervention in the forward exchange market to offset interest-rate differentials.

(b) It would permit exchange-rate variations to play a somewhat larger role in the adjustment process than is now possible.

(c) It would discourage speculation by increasing the risk of losses in relation to the possibilities for profit.⁷⁵

In the Studies and Hearings which preceded the Report several experts made the suggestion that the limits for exchange-rate variations should be broadened.⁷⁶ Since their statements are few in number and brief in content, they can be quoted at full length, thus indicating precisely the position of their authors—inevitably, of course, at the cost of some repetition.

Seymour E. Harris, referring in particular to the United States balance-of-payments problem, holds that there is

no sufficient reason why the gold points for the dollar should not be allowed to vary a few per cent in all up and down as allowed

⁷⁵ *Ibid.*, p. 18.

⁷⁶ *Factors Affecting the United States Balance of Payments*. Compilation of Studies Prepared for the Subcommittee on International Exchange and Payments. Joint Economic Committee, 87th Congress, 2d Session (Washington, 1962), quoted as *Factors*; *Outlook for United States Balance of Payments*. Hearings Before the Subcommittee on International Exchange and Payments. Joint Economic Committee, 87th Congress, 2d Session, December 12, 13, and 14, 1962 (Washington, 1963), quoted as *Outlook*; *The United States Balance of Payments*. Hearings Before the Joint Economic Committee, 88th Congress, 1st Session (Washington, 1963), quoted as *U.S. Balance of Payments*. Willingness among economists to consider the band proposal at least as a second-best solution of the exchange-rate problem is greater than a perusal of the Studies and Hearings might indicate. In recent deliberations of an international study group of economists the band proposal was discussed as a modified form of a system of freely fluctuating exchange rates. Though the economists of the study group had no intention whatever of advocating any special monetary system or reform plan and had come together merely to try to interpret reasons for their disagreements, there was found to exist substantial (though by no means unanimous) agreement on some propositions. Thus many participants felt that the "exchange rates should be allowed to change more frequently than currently contemplated by major governments" and "some previous advocates of unlimited flexibility in exchange rates tended, after consideration, to favor some form of limited flexibility." *International Monetary Arrangements: The Problem of Choice*. Report on the Deliberations of an International Study Group of 32 Economists (Princeton, N.J.: International Finance Section, Princeton University, 1964), pp. 102 and 105-106.

in the International Monetary Fund charter. The result would be a great discouragement of short-term capital movements, one of the most disturbing factors accounting for the gyrations in the balance of payments. A widening of the gold points would introduce an element of uncertainty which would greatly cut these capital movements.⁷⁷

To Philip W. Bell it seems to be utter folly to allow short-term capital flows, other than those which go to financing U.S. exports,

. . . to dictate monetary policy in this country. We can offset the adverse domestic effects of high interest rates by having a large budget deficit, thus achieving the same rate of expansion in income and employment here as we could have with lower interest rates. But why should we? There are alternatives.

The alternative which I suggest is an old one, but one which is, it seems to me, perfectly respectable. Indeed, it is the alternative which is presently practiced by the other great world financial center—London. There is no reason why we have to continue to buy and sell gold at absolutely fixed rates. If we were to widen our gold points so that fixed buying and selling rates were as much as 1 percent or so on either side of \$35 an ounce, as in the case of sterling, we would be in a position of offsetting the short-run effects of practically all of any widening of the London-New York differential or other European-U.S. differentials which is ever likely to occur.⁷⁸

Peter B. Kenen points out that

the narrow spread on the sterling-dollar exchange rate, for example, may make it difficult to manipulate or to operate on the foreign exchange rate so as to offset interest differentials. There is a limit to the forward premium or discount that one can induce, as long as the spot rate is confined within a very narrow range. . . . So I would surely support a recommendation that exchange rates be free to move over a slightly wider range than at present, and also that the free market price of gold be allowed to move more widely.⁷⁹

The present writer suggested that the members of the International Monetary Fund be permitted to widen the margin above and below

⁷⁷ *Factors*, p. 24.

⁷⁸ *Outlook*, p. 127.

⁷⁹ *Outlook*, p. 143.

parity, and that this should be done in conjunction with still closer cooperation of central banks and the greatest possible effort toward harmonization of national economic policies. However, even this mild move toward greater exchange-rate flexibility should wait until the United States balance-of-payments difficulties have been overcome.⁸⁰

Friedrich A. Lutz agrees that the spread between the selling and buying prices of foreign currencies should be still further widened, but considers it a minor point. Like the other advocates of the proposal, he wants to protect the domestic monetary policies against disequilibrating short-term capital movements.

The widening of the spread makes it possible in certain conditions to maintain, temporarily at least, substantial interest rate differentials between countries without causing shifts of short-term funds between those countries on such a large scale as could occur under the gold standard. For when there exists a fairly wide margin within which the exchange rates can fluctuate, the central bank in the country with the relatively high short-term interest rates can, by intervening in the spot and forward exchange markets, make the difference between spot and forward rates so high, and thus make hedging against the exchange risk so expensive, that the volume of funds actually attracted is reduced to small proportions.⁸¹

Robert Mundell is not predominantly interested in offsetting interest-rate differentials. He points to the need for an adjustment mechanism to replace the adjustable-peg system which the International Monetary Fund has failed to implement (through frequent changes of the exchange rates), a failure which "has led us back to the inflation-stagnation methods of the gold standard."

The solution I offer, which would simultaneously solve any potential liquidity problem, is not a very original one, but I am comforted by the thought that it is probably the right one. I recommend a widening of the buying and selling limits on gold, to not less than 7½ percent on either side of par. This would introduce an indispensable flexibility into the international price mechanism without imposing on countries the burdens of stagnation and domestic inflation. The additional exchange rate flexibility would at the same time provide guidelines for non-inflationary monetary

⁸⁰ *Factors*, p. 560; *Outlook*, p. 181.

⁸¹ *U.S. Balance of Payments*, p. 338.

policies. I would expect it to be followed by a dismantling of all those devices imposed for purely balance-of-payments reasons, including things like tied aid, equalization taxes, hidden export subsidies, quotas, and such things. I would further expect that central bank intervention in markets for foreign currencies could be dispensed with and that the outstanding short-term dollar liabilities to foreign central banks could be reduced.⁸²

Mundell proposes a system of limited but unmanaged flexibility to which he ascribes the ability to adjust the trade balance without much difficulty. His system comes very close to a system of freely fluctuating exchange rates.

Alternative Proposals

The Studies and Hearings produced three proposals which must be mentioned separately. Two cannot be classified as proposing clearly a system with broadened limits of exchange-rate variations, and one even suggests the opposite approach, viz., that we eliminate flexibility altogether.

Howard S. Piquet proposes that the United States Treasury should remove the presently existing floor for gold. With the price floor removed, "speculators in gold who are betting that the United States will raise the price of gold, would face the prospect of losses, as well as gains."⁸³

Piquet's argument implies a widening of the spread between the buying and selling prices of gold and the same criticism of the adjustable-peg system that has prompted the proposal for smoother exchange-rate variations within limits. But since Piquet's proposal is limited to speculation in gold and removes the price floor for gold, it would be unfair to claim his support for the band proposal.

A very interesting idea for changing the gold parities is James E. Meade's suggestion for yearly adjustments of up to 2 per cent up or down. Meade proposes

for earnest and immediate consideration a change in the rules of the International Monetary Fund on the following lines:

⁸² *U.S. Balance of Payments*, p. 547.

⁸³ *Factors*, p. 308. Fritz Machlup proposed in 1961 that the price of gold should be reduced by the leading monetary authorities of the free world over a period of several years by, say $\frac{1}{4}$ or 1 per cent every three months. He expects that several billion dollars worth of gold would be dishoarded and offered for sale to the monetary authorities. "Comments on the Balance of Payments and a Proposal to Reduce the Price of Gold," *The Journal of Finance*, Vol. XVI (1961), pp. 186-193.

(1) Each member would as at present fix a gold parity for its national currency.

(2) Each member would be allowed in any year to raise (or lower) this par rate by 2 per cent above (or below) the parity fixed in the preceding year.

(3) Each member would undertake never to raise the price of gold in terms of its own currency by the permitted 2 per cent unless it was at the time incurring a substantial loss of monetary reserves.

(4) Each member would undertake never to lower the price of gold in terms of its own currency by the permitted 2 per cent unless it was at the time incurring a substantial accumulation of monetary reserves.⁸⁴

Meade's proposal must not be interpreted as supporting a widening of the margin above and below parity.⁸⁵ Indeed, it may seem at first sight as if a country's exchange rate were permitted to vary by 4 per cent within any one year. This interpretation is wrong, however, since one and the same country is most unlikely to produce both a "substantial loss of reserves" and a "substantial gain in reserves" in any given year. Furthermore, for the proposal to broaden the limits of permissible exchange-rate variations it is important that the limits should be considered as based on a *fixed* parity and not be themselves interpreted as sliding parities.

A combination of the band proposal with an adjustable parity, i.e., a "movable band" would lose the advantage that is offered by reliance on limited fluctuations around a permanently fixed parity. As it stands, Meade's proposal seems to be even more exposed to the dangers of disequilibrating speculation than the present adjustable-peg system, just as the *Keynes Plan* was more objectionable in this respect than the Bretton Woods solution.⁸⁶

It may seem that Meade's proposal would have the advantage of introducing an element of smoothness into what are now abrupt parity adjustments. But we could achieve this advantage better through a system of flexible but reasonably stable rates of exchange within the limits of a broadened band.

⁸⁴ *Outlook*, pp. 242-243.

⁸⁵ As, e.g., Ervin P. Hexner suggests in *The "Fixed vs. Flexible Exchange Rate" Controversy: Recent Policy Developments*. Bureau of Business Research. College of Business Administration. The Pennsylvania State University, Occasional Paper No. 3, June 1964, p. 7.

⁸⁶ See above, p. 4.

In contradistinction to the proposal to widen the limits of permissible exchange-rate variations, James C. Ingram proposes to bring about financial integration of the trading countries through equilibrating long-term capital movements and *rigidly and permanently* fixed exchange rates. For example

if a given nation expands government expenditures and runs a budget deficit, it must offer higher interest rates to persuade financial markets to take its bonds. An inflow of capital will be attracted to cover the increased imports of goods that may accompany the budget deficit. The capital movement is equilibrating.⁸⁷

Indeed, exchange rates which are rigidly and permanently fixed (i.e., “with *no* spread around the official par value and no provision for any change”) plus financial integration (i.e., “freedom for individuals, firms, banks, and government agencies to trade in securities and other financial claims across international boundaries”)⁸⁸ will create international payments equilibrium. In fact, if these extreme assumptions can be adhered to, the main international payments problem has been abolished by definition, just as it does not exist between the different regions of one and the same country. But with these assumptions we have excluded the facts of life.

In Ingram’s example a budget deficit raises the rate of interest and thereby causes an equilibrating long-term capital flow. But if the budget deficit is the result of intentional deficit spending with the purpose of injecting newly created money into the economy, the rate of interest will be lowered and capital may tend to flow out.

The Brookings Institution Report

The Brookings Institution Report *The United States Balance of Payments in 1968* proposes

a widening of the limits around the par values within which the actual market rates are allowed to fluctuate. The limited fluctuations of exchange rates permitted by such a widening of the support points would have a number of advantages. First, they would give rise to capital movements which, under the conditions specified, would be stabilizing rather than destabilizing and would reduce the need for using official reserves and credit facilities.

⁸⁷ James C. Ingram, *Factors*, pp. 186-187.

⁸⁸ *Ibid.*, pp. 190 and 179.

Second, they would permit greater variability in short-term interest rates among countries than would be possible with absolutely fixed market exchange rates, thus permitting somewhat greater national autonomy in monetary policies. Finally, even the limited variation in exchange rates possible with support points of 2 percent to 3 percent on either side of parity would be helpful in promoting balance-of-payments adjustment. Among industrial countries producing similar products, price elasticities in international trade over periods of several years can be expected to be high, so that small changes in exchange rates would have considerable influence on trade balances.⁸⁹

This clear and comprehensive argument for a widened band unfortunately loses some of its value owing to its position in the context of the Report's policy recommendations.

The Report is correct in pointing out that the present problem is not primarily a balance-of-payments problem of the United States. The real problem is the inadequacy of the international monetary mechanism in relation to the requirements of the Free World. In fact, if the United States did achieve a trade balance or a trade surplus, world liquidity would become insufficient, forcing other countries to cut their imports.

The Report points out that increasing liquidity is needed to give countries time to correct payments disequilibria without compromising more important goals, such as high employment and growth. The present system of fixed rates, "operated with the existing or foreseeable level of reserves"⁹⁰ is dangerous, particularly since it is not a system of permanently fixed rates but an adjustable-peg system. The latter system has these disadvantages: "the efforts to defend an exchange rate are likely to be too long delayed; and devaluations are likely to be excessive when they are finally made."⁹¹

The Report suggests that we can enjoy the advantages of permanently fixed exchange rates and avoid the disadvantages of the adjustable peg provided we have greater liquidity "because it would gradually be recognized that enough time was available to restore

⁸⁹ Walter S. Salant and Associates, *The United States Balance of Payments in 1968* (Washington, D.C.: The Brookings Institution, 1963), p. 251. The associates were Emile Despres, Lawrence B. Krause, Alice M. Rivlin, William A. Salant, and Lorie Tarshis. The Foreword reveals that "Chapter IX on policy proposals was a genuinely joint effort. Although all members do not subscribe to all the points made in it, it reflects the consensus of the group."

⁹⁰ *Ibid.*, p. 246.

⁹¹ *Ibid.*, p. 247.

equilibrium in the payments of the major countries without revaluation of their currencies.”⁹²

The Report then proposes a “satisfactory international monetary mechanism” with the following characteristics: substantially increased liquidity in the form of drawing rights or other credit facilities extended either directly or through international institutions, available readily and promptly and for a period long enough to permit elimination of the deficit; and, since the possibility of shifting reserves from weak to strong currencies must be prevented, international agreements to prevent such shifts, agreements which probably “would have to be accompanied by guarantees of the values of the reserve currencies.”⁹³ This multiple-reserve-currency scheme would, through close cooperation, lead to a coordination of national policies.

The proposed system should make it possible to replace the adjustable-peg system with permanently fixed parities. But “it will take some years, of course, to demonstrate the effectiveness of the system and to build up confidence in the permanence of the parities” and only “when that confidence has been established, a further useful step would be the widening of the limits around the par values within which the actual market rates are allowed to fluctuate.”⁹⁴

Thus the timing of the band proposal is changed. Greater flexibility through exchange-rate variations becomes, as it were, a bonus for having worked for years with a system of very limited flexibility—at least as far as exchange rates are concerned. Yet during these years the adjustable-peg system would still have been in force potentially. Furthermore, it is possible that substantially increased reserves could be interpreted as an invitation to indulge in inflation or to continue misallocation of resources, two possibilities which the Report admits. Both these consequences might lead to peg adjustments.

The Report’s liquidity proposals do not suggest an adjustment mechanism. On the contrary, the Report argues against fixed repayment dates and against conditions under which increased liquidity would be made available. In this respect the Report is very similar to the *Keynes Plan*.

If it is doubtful (either in fact or at least in the eyes of central bankers) that the proposed liquidity system will maintain the discipline needed for a system with rather rigidly and permanently fixed exchange rates, why not substitute greater flexibility of exchange rates, to some

⁹² *Ibid.*, p. 247.

⁹³ *Ibid.*, p. 249.

⁹⁴ *Ibid.*, p. 251.

extent at least, for the requested substantial increase of reserves? The liquidity increase (via drawing rights, etc.) is supposed to be large "because imbalances arising both from persistent and stubborn shifts in basic transactions and short-term capital movements are potentially quite large and are likely to grow."⁹⁵ Increased reserves, however, do not provide a mechanism for dealing with these imbalances, while variations of exchange rates within a widened band admittedly⁹⁶ would provide such a mechanism. The partial substitution of moderate exchange-rate fluctuations for increased reserves, furthermore, would probably provide clearer guidelines for the coordination of national economic policies than increased credit facilities without strings.⁹⁷

The Practical Approach

We have already seen that the operation of an international payments system with broadened margins has to fulfill the precondition of a very close cooperation between central banks. This cooperation has greatly increased in recent years.⁹⁸ Particularly interesting is the entirely new attempt of the United States to operate in the foreign-exchange market to defend "in concert with others, the whole system of convertibility at stable exchange rates that has been so painstakingly reconstructed since the end of World War II."⁹⁹ Robert V. Roosa, Under Secretary of the U.S. Treasury for Monetary Affairs, points out that the United States "foreign exchange operations have so far been mainly designed to help in providing a breathing space during which . . . basic programs could have a chance to become effective. In our judgment, they have been most helpful in deterring unwarranted speculation and unwanted capital flows, and in reducing the drain on our gold stock, which stands as the bulwark of the whole international currency system."¹⁰⁰

⁹⁵ *Ibid.*, p. 249.

⁹⁶ *Ibid.*, p. 251.

⁹⁷ In case a system with fixed exchange rates could not be made to work, the Report proposes "a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc. There would be relatively fixed rates within each bloc and flexible rates between them." *Ibid.*, p. 259. This proposal, which has been repeatedly criticized (see *The United States Balance of Payments. Statements by Economists, Bankers and Others on the Brookings Institution Study, "The United States Balance of Payments in 1968,"* Joint Economic Committee, Washington, 1963), does not impair the basic argument for a broadened band or the general suggestion that in a future system exchange-rate variations may be smaller within than between blocs.

⁹⁸ Whoever doubts this statement should take the trouble of going back to the Tripartite Agreement of 1936 and compare the extent of international monetary cooperation then and now.

⁹⁹ *Factors*, p. 327.

¹⁰⁰ *Ibid.*, p. 328.

Until recently the United States was "content to leave all operations concerning the exchange relations between the dollar and other currencies to the officials of those other countries."¹⁰¹ In other words, the United States had not even made use of the modest possibilities for exchange-rate variations permitted under the rules of the International Monetary Fund. For making use of these permissible exchange-rate variations, Roosa gave reasons which are identical with some of those used by the proponents of a broadened band. While rejecting the idea that the new policy should be used for the rigging of markets or the pegging of prices, he points out that

Within the relatively narrow band which is, in any event, permitted under the rules of the International Monetary Fund, there must be room for market prices to demonstrate the basic strength or weakness of any currency.¹⁰²

And, in another context, he stresses once more "that it is no part of our intention to disguise the basic forces of supply and demand, or the various market evidences of changing needs and conditions in the international financial condition of the United States or any other country. We want and need the sensitive signals of changes in fundamental forces that are reflected in price fluctuations in free markets."¹⁰³

To be fair to Secretary Roosa, it must be emphasized that he does *not* argue for a widening of the band but only for making use of the "relatively narrow" band permitted by the Fund Agreement. However, it may be pointed out that a relatively narrow band can be too narrow to show "the basic strength or weakness of a currency" or to permit "sensitive market signals of changes in fundamental forces." Since Roosa also argues for a "breathing space" for fundamental adjustment and, at least indirectly, for leeway in case of unavoidable differences in national economic policies,¹⁰⁴ he should be open to the suggestion that a careful widening of the band would be desirable. Is it not exactly the rigid fixing of parities which prevents the basic forces of demand and supply from working in the foreign-exchange markets? And why criticize only the pegging of rates within the narrow band and not the pegging that is obligatory at the support points, if these points permit only variations of exchange rates which might be too small?

Central bankers and Treasury officials should remember, too, that,

¹⁰¹ *Ibid.*, p. 328.

¹⁰² *Ibid.*, p. 328.

¹⁰³ *Ibid.*, p. 339.

¹⁰⁴ Criticizing Robert Triffin, he points out that the Superbank cannot work properly "so long as major differences in economic policy arise among different countries." *Factors*, p. 347.

at present, they are not supporting permanently fixed but adjustable exchange rates. They should be attracted by a proposal to eliminate the adjustable-peg system which creates the most dangerous capital movements and to substitute for it smooth price variations within a broadened band.

V. Advantages of a Broadened Band

A Workable Compromise

The band proposal indicates an area of compromise between the principles of fixed and flexible exchange rates, between external and internal equilibrium, and between theory and practice.

Since the proposal aims at creating greater flexibility, it is criticized by the advocates of fixed exchange rates on grounds that it will allow too much freedom for domestic economic policies and lead to financial irresponsibility. But this charge is offset by the claims of others that flexibility within limits does not permit sufficient leeway for national policies aiming at optimum employment and growth.

Since neither external nor internal equilibrium can demand our attention to the exclusion of the other, a good case can be made for exchange-rate variations between limits as a workable compromise. And since the strong theoretical support of flexible exchange rates is met by an even stronger preference by central bankers for fixed rates, the band proposal may be our only chance to overcome the present stalemate in the international monetary debate.

Fully to appreciate the advantages of a compromise proposal, we have to keep all its features in mind and refrain from discussing its individual parts out of context. Rigidly fixed exchange rates are better than exchange rates which vary even within narrow limits—if we insist on complete financial integration of all the major trading countries; and freely fluctuating exchange rates are superior to the band proposal—if we reject all government intervention in the foreign-exchange markets. Advocates of pure systems reject the proposal because they are unwilling to leave their uncompromising positions. But since the claims of the purists are incompatible, an intermediate proposal may have the great advantages of balance and realism which are often lacking in pure, simple, and straightforward systems.

A Substitute for the Adjustable Peg

A system of freely fluctuating exchange rates has no chance whatever of being accepted in the foreseeable future in spite of the strong support which it enjoys among economists. Central bankers support the present system as if it were a system of permanently fixed exchange

rates. They often ignore the important fact that it is not a system of permanently fixed exchange rates but rather an adjustable-peg arrangement in which members have the right to change their parities in case of fundamental disequilibrium, be it internal, external, or both. Accordingly, the present payments system cannot claim the advantages on which the supporters of fixed exchange rates rest their case. The adjustable-peg system, instead of ensuring equilibrium, nationally and internationally, permits *ex post facto* corrections of exchange rates to compensate for external consequences of mistaken internal policies, is detrimental to discipline, creates the disadvantages of prolonged overvaluation and undervaluation, and is bad for external and internal stability. Furthermore, it tends to foster disequilibrating speculation, demands large reserves, and is particularly dangerous in connection with a key-currency arrangement.

The band proposal is to be understood as a substitute for the adjustable-peg system in that it seeks to replace delayed and abrupt parity changes with limited but continuous exchange-rate variations around a permanently fixed parity. Today's problem is not a choice between permanently fixed and flexible rates but between peg adjustments and flexibility.

At present there exists a tendency to make parity changes very rare events because of the unsettling effect of even modest upvaluations. But this trend does not eliminate potential peg adjustments which, under certain conditions, are a right of the members of the International Monetary Fund. Besides, the more rarely the parities are changed the more the member countries are forced into domestic policies which are not conducive to optimum employment and economic growth. In other words, the present system is a bad compromise. It must accept the hardships of a fixed-rate system (which the experts of Bretton Woods wanted to avoid) and is not able to enjoy the advantages which might result from permanently fixed parities.

The band proposal, on the other hand, tries to maintain stable exchange rates while avoiding rigidity. "In linguistics as well as in economics, 'flexible' is not synonymous with 'unstable.' The antithesis of flexibility is not stability but rigidity."¹⁰⁵ The band proposal would permit greater exchange-rate variations around a parity which would stay fixed after the abolition of the adjustable-peg system. The mone-

¹⁰⁵ Egon Sohmen, *International Monetary Problems and the Foreign Exchanges*. Special Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 3.

tary authorities, through intervention within the band, might attempt to iron out the effects of disruptive capital flows. International monetary cooperation of central banks would exclude competitive exchange depreciation and inconsistent cross rates. The system could be said to enjoy flexible or floating exchange rates. Since "to float" suggests to move gently on the surface of a liquid, the term is well suited to describe continuous, modest, and orderly exchange-rate variations.

Limits as Guidelines

It is essential to the band proposal that exchange-rate variations cannot exceed predetermined limits. This feature, which causes some advocates of freely fluctuating exchange rates to reject the proposal or to consider it only a second-best arrangement, has the function of providing guideposts for monetary integration. The support points serve as a constant reminder that the central bank may be called upon to maintain a perfectly elastic supply of foreign exchange (or gold) at the upper limit. The domestic policies of the members of the system must be harmonized to the extent that any remaining deviations can be handled through the equilibrating effect of exchange-rate variations on trade, through equilibrating private capital flows, or through the use of official foreign-exchange (or gold) reserves.

The inescapable need for harmonizing national policies will strengthen the central banks of the member countries in their difficult stand against the inflationary consequences of monopolistic wage and price policies. To this extent, the band proposal can claim for itself the advantage of promoting monetary discipline. It may well be conducive to greater monetary self-control than the adjustable-peg system, which stands ready to correct the external effects of domestic inflation.

In promising to maintain the exchange rates at predetermined limits, the national authorities must remain aware of the limitations which the international payments position imposes on their internal policies. Some supporters of a system with freely flexible exchange rates will reject the band proposal for this very reason: they do not want to have their pursuit of domestic expansion hindered by balance-of-payments considerations and believe that freely fluctuating exchange rates will free them from this necessity. They are wrong in that they dangerously exaggerate the capacity of their proposed system. Therefore, it is one of the virtues of the band proposal that it divides the camp of the advocates of flexible rates into two distinct groups: those who want

freedom for domestic policies at all costs and would accept whatever exchange-rate fluctuations might be the consequence; and those who want stable but not rigidly fixed exchange rates. Since these two groups differ in their basic economic philosophy, they should be more clearly distinguished than they are at present. Advocates of freely flexible but stable exchange rates are likely to accept the band proposal as a second-best choice; proponents of the primacy of domestic expansion are bound to reject it.

The Adjustment Process

Exchange-rate variations within a broadened band will induce instant and automatic adjustments in the balance of trade. When the exchange rates are permitted to react as real market prices to changes of demand and supply in the foreign-exchange markets, the following advantages are gained:

(1) All domestic prices are instantly changed for foreign buyers and all foreign prices for domestic buyers since the national price structures are now connected by an elastic link of variable exchange rates. A depreciation of the currency of a deficit country, for instance, will tend to increase exports and reduce imports.

(2) To the extent that exchange-rate variations help produce balance-of-payments equilibrium, we can avoid the difficult, painful, and dangerous attempt to lower (or raise) the whole national price structure through contractionist (or expansionist) monetary policies.

(3) Interest rates and domestic monetary policies would be influenced to a lesser degree by the balance-of-payments situation than under a system with fixed exchange rates. It must be understood, however, that these policies and interest rates can never be entirely independent of balance-of-payments considerations.

(4) Real market forces would take care of immediate trade adjustments, while the support points and the variations of the exchange rates within the band would provide guidelines for the harmonization of national economic policies.

When demand and supply change in the foreign-exchange market it is normally quite natural for the rate of exchange to react and, in reacting, to help bring about a new equilibrium. Only when we believe that these exchange-rate variations are caused by disequilibrating speculation or that they will soon reverse themselves will it be wise to iron them out by official sales or purchases of foreign exchange or gold.

Rigidly fixed parities mean that we prevent the forces of demand and supply from working in the foreign-exchange market and that we violate thereby the basic principle on which the organization of a market economy rests. For no sufficient reason we deprive ourselves of the services of a built-in stabilizer (which we trust in all other markets), delay adjustments, let the external disequilibrium get worse through under- or over-valuation of currencies, and force ourselves to substitute an *artificial* change in bank rates for the *natural* exchange-rate variations which we eliminate when we fix rigid parities. And eventually we may even have to give up these parities through peg adjustments.

Exchange-rate variations free interest rates from unnecessary interference. The bank rate can now be determined primarily according to the requirements of internal economic policies of the member countries, i.e., interest rates would normally not be changed under foreign pressure to produce changes in price levels and in the balance of payments.

Regulation of bank rates is one of the most important instruments of economic policy in market economies, where we try to limit government policies to indirect controls. Through bank-rate changes the monetary authorities attempt to achieve price stability and optimum employment, two aims of internal policy whose achievement fosters rather than hinders external equilibrium. It is most desirable, therefore, that monetary policy should not be deflected from these important tasks by rigid exchange rates and their consequences. If exchange-rate variations can take care of the maintenance of external equilibrium, bank-rate policy is greatly strengthened and it becomes unnecessary to operate monetary and fiscal policies at cross purposes. A broadened band will permit exchange-rate and bank-rate changes to divide the task between them: exchange-rate variations would automatically and instantly work for external equilibrium, and interest-rate changes would be oriented toward the achievement of internal equilibrium. And both equilibria would support each other.

Of course, where excessive deviations of a country's behavior from the behavior of the rest of the international community were the reason for severe external disequilibrium, the domestic policies would have to be changed. But this is not an argument for instant changes in interest rates upon the slightest external imbalance, as in the case of rigid parities.

Internal and external equilibrium are not always in conflict. On the contrary, if the members of an international payments system can maintain satisfactory employment levels and reasonably stable prices, they contribute thereby to external equilibrium. Balance-of-payments trouble often originates with countries which are either unable to maintain a reasonably high level of economic activity, or do so at the expense of permitting themselves a price inflation which exceeds the inflation average of the rest. If monetary policy can be made more successful in maintaining internal equilibrium, exchange-rate variations can be said to help achieve external equilibrium in two ways: directly through their equilibrating influence on the trade balance, and indirectly through the fact that they free domestic monetary policies from unnecessary constraints and enhance their power to achieve domestic stability which, in turn, is conducive to international equilibrium.

A third important contribution lies in the effect that limited exchange-rate variations have on capital movements.

The Band Proposal and Capital Movements

Exchange-rate variations within a broadened band help bring about external balance through their favorable effect on private short-term capital movements. Private funds are attracted when they finance temporary and reversible disequilibria or when they are desirable because they permit more time for necessary basic adjustments; but disequilibrating capital movements from deficit to surplus countries can easily be prevented.

Where gains from exchange-rate variations are added to profits from interest-rate differentials, the widening of the band encourages equilibrating capital movements. This is the case, known from the gold-standard mechanism, where the deficit country has high and the surplus country low interest rates and where capital flows from the surplus to the deficit country, not only because of this differential but also because speculators buy the depreciated deficit currency in expectation of a rebound.

Against the argument that these equilibrating capital movements would undermine monetary discipline in the deficit country, we can say: (1) that adjustments in trade and production always take time, even if flexible exchange rates *start* the adjustment process automatically and instantly, and that in the meantime equilibrating capital

movements are just as desirable as are foreign-exchange reserves; (2) that it is always better that adjustments be gentle rather than harsh and exchange-rate variations smooth rather than abrupt; and (3) that capital imports may remove the need for basic adjustments when disequilibria are only temporary and reversible.

A broadened band could insulate the member countries against undesirable influences from abroad. At rigid parities, interest-rate differentials between countries will cause capital movements from the low-interest to the high-interest country. These capital movements may interfere with the domestic economic policies of the countries concerned, which use bank-rate changes for either anti-inflation or anti-depression purposes.

A high interest rate in *S*, the surplus country, which is supposed to dampen an inflationary expansion will attract funds from deficit country *D*. In country *S* the capital inflow increases the supply of foreign exchange. By acquiring *D*-currency to maintain the fixed parity, country *S* increases its monetary circulation and violates its own anti-inflation policy. If, on the other hand, the rate of exchange were permitted to vary, the price of *S*-currency would rise in terms of *D*-money and act as counterweight to the interest-rate differential. The disequilibrating capital flow would not take place.

If deficit country *D* has low interest rates to stimulate domestic investment, the flow of capital to country *S* will be undesirable because it will increase the balance-of-payments disequilibrium and may force country *D* either to stop its expansionist policies, to devalue, or to give up convertibility. Again, if the rate of exchange were permitted to vary, the price of *S*-currency would rise in terms of *D*-money. This would prevent capital from leaving country *D* even though *D* continues its low-interest policy to stimulate investment and employment.

If we reverse the example and let the surplus country maintain low rates of interest owing to domestic depression and the desire to expand, the capital flow need not be disturbing, because the surplus country can afford a reduction in its surplus and can consider investment in the deficit country a work-creating measure from the standpoint of its domestic economy. We need not argue that the capital outflow would be detrimental because it would increase the rate of interest. Owing to its expansionist policies the depression country pursues a policy of credit creation which can easily compensate for the effect of the capital movement on the domestic rate of interest.

We note that in this case, where the capital flow would be desirable from the standpoint of both external and internal equilibrium, interest-rate differentials and exchange-rate variations would, once more, pull in the same direction, because the flow of capital to the deficit country would be fostered by both high rates of interest and a temporarily low price of its currency.

It cannot be expected that the forces which are at work in the credit and foreign-exchange markets will always support equilibrating and discourage disequilibrating capital movements in amounts which are best suited for the situation at hand. The national monetary authorities, therefore, may want to intervene in the foreign-exchange market just as they intervene in the credit market. They could, for instance, determine the exact size of exchange-rate variations needed to offset a given interest-rate differential, which, in turn, is determined by the requirements of the internal policies of the different countries.

Exchange-rate variations within a broadened band are not only an important instrument of the monetary authority which can influence these variations, they are also a sensitive index for ascertaining the growing strength or weakness of a currency. This index, which is a clear price signal, is more straightforward than the gauge which we have to use in a system with fixed exchange rates. That gauge consists of changes in international reserves which are difficult to measure. The determination of the amount of available international reserves, which is a prior step in determining a change in reserves, is initially very hard since reserves do not consist only of officially held foreign balances and gold, but also of habitual credit relations and customary borrowing rights. If we add private foreign-exchange reserves, the picture becomes even more opaque. It is difficult to understand, therefore, why a system of limited exchange-rate variations should be criticized for lowering monetary discipline, when it can gauge the situation (as far as external disequilibrium is concerned) better than a system deprived of an effective market signal.

The Width of the Band

The most important strategic question in connection with the band proposal concerns the width of the band.

For those who have not yet made use of the possibilities which even the Fund Agreement provides, it may be a new and satisfactory experience to let the exchange rate move within the permitted modest range.

The United States monetary authorities found this to be true. Since the range set by the Fund is only 2 per cent, we may assume that double that range would amplify the benefits of these limited exchange-rate variations without danger to external or internal monetary stability.

The range we choose depends on whether we want to stress the regulation of private capital movements or the direct effect of exchange-rate fluctuations on imports and exports. The advocates of the proposal who are interested mainly in counteracting undesirable capital movements need not argue for exchange-rate variations much wider than those presently permitted. A doubling of the present range would probably prove quite sufficient. But a width of the band of only 4 per cent may not permit exchange-rate variations which would influence trade transactions decisively. Some experts believe that for this purpose spreads up to 10 or 15 per cent may be needed.

It is a great practical advantage of the band proposal that it can be introduced gradually as we gain experience and courage. But it is also possible that the full advantages of the proposal can only be had when the variations are large enough to shoulder a substantial part of the adjustment burden. If we are too timid we may never know what we are missing.

We must remember, furthermore, that the monetary authorities are in constant command of the situation, whatever the width of the band may be. The rate may never have to reach the set limits because a careful operation of the system keeps the rate close to parity. If the system should not work well, the rates would tend to get stuck at the support points and the whole arrangement would prove no better, but also no worse, than the present adjustable-peg system.

Should the new arrangement reach such perfection that exchange-rate variations would always stay comfortably within the band, we could remove the support points because they would serve no purpose. Thus a boy may remove the training wheels from his bicycle after he has learned to balance. Whether we had the limits on the books or not would become a matter of indifference. We should have reached the ideal system of simultaneously flexible and stable exchange rates.

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ESSAYS IN INTERNATIONAL FINANCE

† No. 1. Friedrich A. Lutz, *International Monetary Mechanisms: The Keynes and White Proposals*. (July 1943)

- † 2. Frank D. Graham, *Fundamentals of International Monetary Policy*. (Autumn 1943)
- † 3. Richard A. Lester, *International Aspects of Wartime Monetary Experience*. (Aug. 1944)
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**MATERIAL EXCERPTED FROM "DISCUSSION 2" BY
FRANCO MODIGLIANI, PROFESSOR OF INDUSTRIAL
MANAGEMENT, MASSACHUSETTS INSTITUTE OF
TECHNOLOGY**

Article appears in the 1964 Annual Report of the Federal Reserve Bank of Boston, entitled "A Critique of Central Banking in the United States."

* * * * *

GROWING FLOW OF CAPITAL EXPORT

The contraction of 1960 that terminated that episode also marked the beginning of the era which has not ended yet, in which monetary policy was significantly cramped by balance-of-payments considerations. That problem is still with us, in spite of the very substantial improvement of the balance on current account, because the real source of difficulty lies not in the current account but instead in the large and growing flow of capital exports, both short term and long term and in the danger that an easier monetary policy would have encouraged yet larger movements by increasing the differential between domestic yields and the returns obtainable in other countries. Thus, in the last analysis the root of the problem is that, under present arrangements, the central bank has largely lost the possibility of pursuing the kind of monetary and interest rate policy which is best suited from the domestic point of view, or, as Mr. Wallich puts it, that "differential interest rate policies [are becoming] as difficult among nations as they are today among Federal Reserve districts." However, he goes on to say "There is a grain of truth in this assertion and *I would like to see that grain grow*" [italics mine]. It is precisely at this point that we most decidedly part ways. I feel that one of the most momentous and pressing problems of the day consists precisely in finding suitable ways of modifying the existing institutions, domestic and international, in order to restore a substantial measure of freedom of action to the monetary policy pursued by a country.

Admittedly, even in the one-interest world that Professor Wallich relishes, countries would not lose all means of pursuing full employment. However, having lost the tool of monetary policy they would have to rely entirely, or at least primarily, on fiscal policies. In essence, the goal of fiscal policy would become that of absorbing an appropriate portion of private saving via deficit, or of augmenting private saving via Government surplus, to the extent necessary so that the resulting flow of saving available for private capital formation could be absorbed at the interest rate level prevailing internationally. There are a number of reasons why reliance on the above approach, though conceivable, does not appear at all appealing. In the first place, if one were to rely on fiscal policies as the only stabilization

device in the shorter as well as in the longer run, one would need an arsenal of quite flexible instruments that one could use rather minutely and accurately. Obviously, at least in the United States today, such an arsenal does not exist and is hard to conceive. Federal revenues and expenditure programs, in contrast to open market and other monetary policies, require congressional action. Such action is slow and uncertain as to both size and timing, as the recent experience with the tax cut clearly illustrates. Proposals to give the President standby authority to make certain changes in taxes, such as were advanced by the Commission on Money and Credit, have so far gotten nowhere and the prognosis is rather unfavorable.

In the second place, even if the above system could be made to work I can see very little merit in a one-interest world, unless there was at the same time a common fiscal and monetary policy such as we have today among the various Federal Reserve districts; or else all participating countries were on the classical gold standard and wages and prices were sufficiently flexible so as to bring about speedily the adjustments necessary for the maintenance of full employment. Under such a gold standard, if it could be made to work, prevalence of a common level of interest rates for all countries would indeed have desirable connotations, for it would imply an optimal allocation of capital among nations. But if the quality of interest rates is brought about not by way of international transfer of resources tending to equalize yields, but by way of budget surplus and deficits modifying the rate of capital formation and the stock of capital in each country until they have the same marginal yield, then I can see absolutely nothing optimal or even desirable about the uniformity of yields.

Since I can see no chance of achieving in the near future sufficient price and wage flexibility to make the gold standard workable or any substantial degree of worldwide integration of monetary and fiscal policies, I conclude that, at least for the moment, we need to work toward a system in which each country has enough freedom to pursue appropriate domestic monetary policies even though this might require the coexistence at any point of time of quite different levels of interest rates.

FLOATING EXCHANGE RATES

The most straightforward and obvious device for achieving this goal consists of course in the adoption of a floating exchange rate. Under such a setup each country could pursue the most suitable domestic monetary and fiscal policy without having to worry about balance-of-payments implications; indeed, there could not be any such thing as a balance-of-payments problem, at least in the sense in which such problems exist today. Interest rate differentials might well exist but would either be offset by an appropriate discount in the forward rate, leaving no opportunity for covered interest rate arbitrage, or would be accompanied by a real transfer of resources.

But once more, for a number of reasons at least some of which are fairly convincing, I can see little ground for holding that in the near future the present system of fixed parities will be (or even should be) discarded in favor of floating exchanges. The real problem, therefore, is how far, and in what ways, can we insure some measure of independence to monetary policy within the basic framework of fixed

exchanges and a minimum of interference with the free international movement of goods and capital. As I see it the problem is by no means insoluble, although it may somewhat tax our ingenuity. In seeking an answer it is useful to distinguish between differentials in short-term rates and measures to prevent such differentials from bringing about large-scale movements of short-term capital, and the problem of long-term capital movements, whether portfolio or direct.

DEVIATIONS FROM OFFICIAL PARITY

With respect to the first problem, a fairly satisfactory answer is available with but minor changes in the present institutions. It consists simply of increasing the spread between upper and lower limits of the range of permissible deviations from the official exchange parity. Under the present arrangements countries which are members in good standing of the International Monetary Fund are required to intervene by buying or selling their currency only when the discount or premium on the dollar exceeds 1 percent of official parity. Thus the rate of exchange between the dollar and any other currency can deviate from parity at most by 1 percent in either direction, while the exchange between any two other currencies can deviate from parity by 2 percent in either direction. In practice, the range that many central banks have been willing to tolerate has been even smaller. In particular, the range of fluctuation of the pound has been kept between \$2.78 and \$2.82, or within some two-thirds of 1 percent of parity. This range—or even the binding 1-percent range—is too narrow to permit the development and maintenance of a spread between the forward and the spot rate large enough to prevent the emerging of a covered spread between domestic and foreign short-term rates. This is especially true when the differential between the actual rates is appreciable and likely to last for some length of time, and no change is anticipated in the official parity. If, however, the range were increased to, say 3 percent of official parity, then, by relying if necessary on official intervention on the forward as well as spot market, it would be possible to have substantial differences of some duration between short-term rates without the emergence of a significant covered differential. Furthermore, the wider range would also make it more important for those prepared to exploit the interest differential to secure forward cover. Whether the appropriate range should be increased to 3 percent or to some other figure is a matter of detail which needs to be settled by negotiations among the participants, but the general principle of increasing the spread sufficiently to restore an adequate measure of independence between the short rates in different countries is something which we should proceed to explore right now, when there is no current or imminent crisis confronting the dollar. Incidentally, it should be made clear that the reason we need to permit substantial differentials between short rates without giving rise to large short-term capital flows is not that short rates per se have necessarily a very large influence in aggregate demand, but rather that a determinate policy of monetary ease or restraint becomes impossible if one needs to keep the short rate within a narrow range.

I believe that the above very minor reform would go a good deal of the way in the direction of reestablishing the needed freedom of action in domestic monetary policies. Furthermore, the elimination

or substantial reduction in short-term capital movements that the above measure aims to bring about is achieved without interfering with the freedom of action of traders, or significant loss of efficiency in the allocation of resources. Indeed, as far as I can see, short-term movements of liquidity reserves in response to short-term yield differentials arising from the pursuit of monetary policies with different degrees of tightness as required by domestic conditions; perform no useful function, except to make it harder for each central bank to pursue the appropriate policy. The country that is trying to expand its money supply may find this attempt thwarted by capital exports which are not accompanied by a net transfer of goods, and result instead in the transfer of at least some portion of the expanded money supply in the hands of the central bank of the host country. And similarly, the country trying to hold down the money supply may find its attempt to do so equally thwarted by a surplus in its balance of payments.

It is conceivable that elimination of incentives to international movements of liquidity in response to differentials in short-term yields may not be quite sufficient to provide the required elbowroom. Long-term investments, especially portfolio investments, are in principle also responsive to differences in the long-term yields, in a climate in which the maintenance of the current parity is regarded as pretty certain, and this might again interfere with central bank policies endeavoring to affect long-term rates in the desired direction. Under these conditions it may be necessary to place some additional obstacles to capital exports, such as our recent interest equalization tax, or the proposed legislation, which never cleared Congress, to eliminate some of the present tax advantages granted to income arising from direct investments abroad. Measures of this kind, that involve relatively little interference with the freedom of choice of individual operators, can be supplemented by more direct controls such as licensing of foreign issues floated in the American market. Such actions pose more serious questions since they involve much greater interference and much greater likelihood of significant misallocation of resources, to the point where the cost may be deemed even greater than that of tolerating some unemployment for some time and of that of occasional changes in the official parity.

Whether or not the elimination of short-term capital movements through wider ranges of permissible exchange fluctuations plus minimal interference measures such as the interest equalization tax, and ample international liquidity would prove sufficient to provide the needed freedom in domestic policy without recourse to harsher measures, is something that cannot be easily foretold. But again, I would feel that this is the time, while the whole issue of international liquidity is under review, to study carefully which institutions should be modified and what remedial action should be open to participating countries for the purpose of reestablishing an adequate measure of freedom to domestic monetary policy. As indicated earlier, I feel that this, at least in the United States, is indeed one of the most pressing and momentous economic issues of the current decade.

APPENDIX

MATERIALS RELATED TO THE ADVANTAGES AND
DISADVANTAGES OF CHANGES IN THE GOLD-BUYING
POLICY OF THE UNITED STATES

Submitted by
Senator JACOB K. JAVITS

APPENDIX

The material following has been included in the record at the request of Senator Jacob K. Javits. The material relates to proposed changes in the U.S. gold buying policy and includes replies to Senator Javits' letter of June 22, 1965, as well as relevant articles dealing with the subject.

The following letter was sent to a number of leading international economists:

JUNE 22, 1965.

Dear _____:

It is expected that the Joint Economic Committee will hold hearings late in July on reform of the international monetary system. I believe it would be useful if the record of those hearings contained expressions of opinion of leading international economists on proposals which have been advanced in recent years relating to a modification of the U.S. gold buying policy.

As you know, various plans to eliminate or modify the U.S. guarantee to buy gold at \$35 an ounce, or at any other predetermined price, have been made by Prof. Fritz Machlup, Prof. Emile Despres, Dr. Howard S. Piquet, and Donald Cook. In 1962, the minority members of the Joint Economic Committee suggested that such a plan might be given consideration as one means of reducing speculation in gold against the dollar. Here is an excerpt from that report:

* * * One step which might be considered to help stem the outflow of gold would be for the United States to terminate its guarantee to buy gold from foreigners at \$35 per ounce or at any other predetermined price. At the same time, we believe that the United States must avoid devaluation by continuing to sell gold to foreigners at \$35 an ounce * * *

My colleagues on the committee and I would be grateful for your opinion on the general idea of modifying our gold buying policy and/or on any of the particular plans which have been advanced. If you have no objection to publication of your views, I will ask that they be included in the record of the hearings to which I have referred.

With best wishes,

Sincerely,

JACOB K. JAVITS, U.S.S.
Ranking Minority Member, J.E.C.

The following article is excerpted from the American Banker, issue of May 4, 1965:

NEW GOLD POLICY, WORLD RESERVE CURRENCY ADVOCATED BY COOK

(By Ben Weberman)

NEW YORK.—Donald C. Cook, president of American Electric Power Co., who is still among President Johnson's close advisers in domestic and foreign financial affairs, is one who advocates a new gold policy for this country and would like to see progress moving in the direction of a new international reserve currency.

These views were revealed in an interview with the progressive utility executive, who was unable to accept the post of Secretary of the Treasury when it was offered by the President but who has remained a friend and confidant of Mr. Johnson.

For that reason, much weight must be given to his view that the United States could curb gold speculation by terminating the standing offer to buy gold at \$35 an ounce (less a modest handling charge).

The United States would continue to redeem dollars for gold at \$35 an ounce—that is the measure which fixes the value of the dollar—but is acting rather foolishly to stand ready under all circumstances to pay that price for all the metal offered to it, he declared.

The merit of accepting such a new policy is that gold speculation again would hold considerable risk.

The speculator would no longer have a "put" on the United States enabling him to resell the yellow metal at any time at a price close to cost—

Mr. Cook declared.

Up to now, the only cost of speculation is barely more than loss of income that could otherwise be earned on funds sterilized in gold. This is not nearly enough to dampen the demand of speculators who think they are playing for big profits from the hoped for devaluation of the pound or the dollar, he explained.

The realization that gold could drop to \$30, \$25 an ounce—or lower—would certainly tend to dampen speculative purchases of gold and could even bring quite a bit back to the Government stockpile from privately held supplies. It might also reduce the appetite of some countries for increased amounts of gold for reserve purposes.

At the same time, he urged moving ahead toward the adoption of a new international monetary reserve unit to be used in settlement of payments balances. The possibility of worldwide acceptance of this concept has been greatly enhanced as a result of the success of the American efforts to solve the country's balance-of-payments problem by restricting capital exports and the realization that an American surplus will produce deficits and possibly economic contraction abroad, Mr. Cook indicated.

This has highlighted the basic inadequacy of existing monetary mechanisms and placed in bold relief the need for reform, he added. He likened the potential system to the Federal Reserve assistance in settling interbank balances.

In Mr. Cook's opinion, the chief stumbling block to successful development of a reserve unit would be the difficulty in establishing one which has the stability and therefore would be readily accepted by all payments surplus countries.

A possible answer would be complete separation of the obligation of each country to the sponsoring international entity on the one hand and to everyone else on the other.

Stability then could be achieved by imposing a requirement that each country protect the value of its own subscription made in its own currency value against inflation or devaluation. Thus, if the relative price of a country's currency were reduced—through either devaluation or inflationary loss of purchasing power—more currency would have to be contributed to the entity to offset the difference.

This requirement, Mr. Cook added, would have the additional merit of bringing pressure on member countries to control their own economic affairs in such a way as to insure fiscal responsibility.

Some form of international reserve unit has been backed by virtually every country which is a party to the International Monetary Fund. The French favor such a unit, too, though they have perverted the idea by trying to tie settlements to gold and there just isn't enough gold in the world for such a purpose. To mark up the price of gold, to enable gold to stay in the picture as Mr. Rueff has proposed, would be sheer lunacy for us, catastrophe for our friends, and a highly successful speculation for France, which could then sell back to us for \$70 or \$105, or whatever an ounce the gold it has so recently purchased for \$35 an ounce from us.

Mr. Cook was only slightly concerned about the U.S. balance-of-payments problem.

The belief that this country has a terrible balance-of-payments problem and that it could wreck our economy is all wrong—

he asserted.

He predicted that within 6 to 12 months, some of the European governments which have been calling most loudly for elimination of the U.S. deficit and for curtailment of U.S. investment in their industries would not only be letting up on the criticism but would be willing—indeed would desire—to see a continued deficit in the U.S. international payments. They would realize, he explained, that this country's deficit is not structural but results from exports of short-term and long-term capital which is necessary to their own economies.

An additional way of curbing speculation in gold, Mr. Cook said, could be done by raising the charges on official sales to say 1 percent or 35 cents an ounce. This would immediately serve to deter some of those who now buy gold on very slim margins—often no more than 3 percent or 5 percent. Ultimate sale back to the United States—if this country were to continue to be a buyer, would be at \$35 less 1 percent and the 2 percent charge for the round trip which would wipe out a good part of the cash investment.

Furthermore, if the United States were to say, in effect, that it will sell gold at \$35 to the full extent of the \$14.5 billion stockpile if necessary but is not necessarily going to pay that price for the yellow metal, a considerable amount would come out of privately owned supply.

There is no reason why speculators should have a virtually cost-free perpetual "put" on the United States of gold at \$35 an ounce, he declared. It would cost up to 10 percent to buy 1-year option to "put" common stock where there is free-market risk, he explained.

The chief uncertainty which Mr. Cook feels about the U.S. effort to curb the balance-of-payments deficit is whether this country could be insulated from European recessions.

There is no question about the possibility that withdrawal of dollars from European money and capital markets will be tightening credit and curbing expansion in several countries. This is already evident in Italy and the United Kingdom, for example.

But the key question for U.S. policy is whether the spillover of recessionary tendency would be felt here. It may be necessary to face up to this problem before it really develops, Mr. Cook declared.

Actually, he explained, any one of the three things could happen.

Such a hue and cry could be raised in Europe about the Johnson voluntary program that we will ease up. But this would require the European countries to admit that they have been wrong about the impact of the U.S. deficit. Some of them now admit it, but I don't think all of them will. Many Europeans who have been complaining the loudest are doing so on the basis of a deep-seated fear of competition from American corporations in their home markets.

The second possibility—

He said—

is that we will have the unfortunate experience of being pushed into correcting something (the payments deficit) when it is not computed properly.

He explained that we charge ourselves with short-term capital outflows but do not credit ourselves with short-term inflows, thus greatly overstating the so-called deficit in our balance of payments.

The third choice, and the one apparently most favored by Mr. Cook, involves—

broader recognition of the need for reform of the international monetary system.

There is no reason why the dollar should have to carry worldwide responsibility for providing reserves and maintaining international liquidity—

he declared—

This task can and should be shared by all major countries through an international organization that would issue an international monetary unit having protection of its stability.

The development and use of such a unit, too, would permit U.S. corporations, including banks, to resume the export of capital without being charged with creating a balance-of-payments deficit, endangering the economy, and generally acting unpatriotically. He added that the United States is the only real capital market in the world and this would permit us to make U.S. capital freely available abroad to the great profit of both parties to the transaction.

The following syndicated¹ article by Eliot Janeway appeared in the Evening Star, Washington, D.C., May 24, 1965:

SPECULATION AGAINST DOLLAR CONTINUES

(By Eliot Janeway)

NEW YORK.—The famous dollar deficit, that was plaguing us so sorely until a couple of months ago, has been brought under control. In fact, it has overnight been turned into a surplus.

¹ Chicago Tribune-New York News Syndicate, Inc.

But the undercover speculation against the dollar still goes on. Although it's undercover, it isn't really obscure. Last autumn, when the raid against the pound sterling reached its climax, the word was that "the gnomes of Zurich" were betting on British currency devaluation. But it's no clique of private operators who are gambling in calls on the future price of gold as a bet on U.S. currency devaluation.

The speculative ring is centered in European officialdom. Worse still, the ringleaders of this stubborn speculation against the dollar—and, therefore, against the United States—are the European central banks, themselves.

The play that speculators have in mind is simple enough. They are taking gold from us at \$35 an ounce. They have only one use for it: To hold it in margin accounts until, as they anticipate, we have been weakened and forced to devalue. Then, they propose to sell it back to us at \$70 to \$100 an ounce—or whatever we, in our future presumed weakness, are forced to accept from them in their future presumed strength, as the new price of gold.

Some speculators gamble by putting up their own hard cash. But the European central bankers who are playing this game for a free ride are tying up the savings of their own people and diverting working capital from productive use. For the gold speculation against the dollar is all done with borrowed money.

Our own Government is underwriting their speculation against our currency by giving a de facto guarantee that it will buy back gold at \$35 an ounce. And this guarantee makes the speculation on gold a "can't lose," free raffle ticket.

There's a simple way to show these best friends of ours, as these speculators against the dollar officially are, that we mean to break up this ball game. It's for our Government to start playing hardball instead of softball. All the administration need do is pass the word on the Washington cocktail circuit that, while we'll of course go on selling gold to buyers at \$35 an ounce, we won't necessarily be ready to buy it back.

To pull the floor out from under the price of gold is to pull the rug out from under the speculators against the dollar and, incidentally, to remind our good friends that up to now they've done pretty well playing on our side. The time to make this move is now, when we can do it from strength because we're back in a surplus payments position.

The calculation which inspires the speculation on gold is that the United States will be weak. But at the same time, the people speculating against us are counting on the fundamental strength of the United States and betting that they can always get out free by selling their margin accounts to us. You can bet your last Swiss franc that, if our Government lets it be known that we won't necessarily buy back gold, no other Government will step up with a \$35 commitment to bail out the speculators.

There's an additional incentive for us to play our self-interest against these short-sighted and greedy allies of ours. If we put a big question mark around our willingness to buy gold back at \$35, we'll serve notice on Russia not to bank on any extra bonus for the gold her mines ship to the West.

PROPOSAL RE CHANGE IN U.S. GOLD POLICY

A PROPOSAL FOR STRENGTHENING THE DOLLAR

(By Emile Despres, Stanford University)

In defending the dollar, the Government has pursued two major lines of policy. First, it has sought to strengthen the balance of payments without gravely compromising other basic domestic or foreign policy objectives. Second, it has sought, through cooperation of European central banks and treasuries, to minimize the drain of gold from the United States by maintaining and expanding the use of the dollar as a reserve currency and by arranging supplementary financing devices for meeting speculative pressures and other strains. It was hoped that such cooperation would grow as the imbalance in international payments was corrected and that further expansion of reciprocal financing devices would provide the base from which a strengthened and durable international monetary framework would evolve.

The first line of policy has been highly successful in strengthening the balance of payments, and the cost in terms of other basic domestic and foreign policy objectives appears so far to have been tolerable. The U.S. competitive position in world markets has become exceedingly strong; the export surplus in goods and services is larger than even the most optimistic forecasters could have dared to predict a few years ago. More recently, the balance-of-payments problem has been concentrated in the capital account but the new voluntary controls are proving initially effective in restricting the outflow of U.S. capital. As a result, our present balance-of-payments position is definitely one of strength, as is shown in detail in Walter Salant's recent testimony before the Senate Banking and Currency Committee.

On this point, the officially designated "deficit," unfortunately still used in the Government's balance-of-payments releases and, therefore, accepted by the public as the key indicator, is a barrier to understanding of the real position and a misleading guide to policy. Foreign investment and lending by the United States properly serve not merely to finance the current account surplus but also provide some additional dollars to permit foreign balances to grow. With a workable international monetary framework, a position of balance in U.S. international payments would be one in which capital outflow provides enough dollars to the rest of the world to supply nearly all the increase in foreign balances in the United States required to meet normal year-to-year growth in foreign demands for liquid dollar funds occasioned by the expansion of the world economy and of international trade and finance. The officially designated "deficit" ignores this second source of foreign demand for dollars. It treats as a deficit any increase in short-term liabilities to foreigners not matched 100 percent by additions to the U.S. gold and foreign exchange reserves. In effect, this concept denies the basic principle of banking and ignores a critically important aspect of this country's role as world banker and financial intermediary. Thus, the official concept is biased toward deficit, so that a state of balance or of moderate surplus in U.S. international accounts appears, under the official concept, as a deficit. It would be conservative, I believe, to consider an officially designated

“deficit” below \$2 billion as representing, properly speaking, a position of surplus. Viewed in these terms, the position today is surely one of considerable surplus.

The present strong position does depend in part on the effectiveness of the new voluntary controls on U.S. private capital outflow. There is no reason to assume that these controls will suddenly and rapidly become ineffective, but voluntary controls do not wear well and erosion must be expected. The guideline controls are probably at their peak of effectiveness now. Moreover, the sharp rise in foreign short-term borrowing in late 1964 and early 1965 is now producing a temporary spurt in the backflow of repayments.

The second major line of policy, the appeal for central bank cooperation, has become ineffective. It did succeed until late 1964 in holding gold losses to a small figure but this was accomplished at considerable cost. First, it left behind an overhang of reluctantly held foreign official balances. Second, this country's efforts to persuade European central banks to keep accumulating dollars as a gesture of international cooperation and its evident reluctance to incur gold losses also contributed to the unfavorable climate of attitudes regarding the dollar and stimulated the appetite of others for gold. The use of the dollar as a reserve currency, instead of being regarded as a facility which the United States was willing to provide for the benefit of countries desiring to hold dollar reserves, came to be considered an arrangement which this country was striving to preserve for its own purposes. A bank which seeks to increase its deposits in this fashion inevitably arouses uneasiness in the minds of its depositors.

Recent events—the impasse in the discussions at the IMF meeting in Tokyo last September, De Gaulle's position on gold, and substantial conversion of dollar balances into gold by European official holders—make it unmistakably clear that the United States has reached the end of the line in appealing for European central bank cooperation. The hope that by strengthening of our balance of payments we would restore confidence in the dollar, increase the willingness of foreign central banks to hold dollar reserves, and create a favorable climate for enlarging the scope of international monetary cooperation has proved to be unrealizable. Although our balance of payments has become strong, gold losses have increased owing to substantial central bank conversions of dollars into gold. The balance of payments is strong but the dollar remains weak. This must seem paradoxical to those who have maintained that the dollar problem was a balance-of-payments problem and that as soon as this country's international payments were brought into balance all would be well.

The long-term objective which this country sought to achieve through central bank cooperation was to strengthen the international monetary mechanism by increased use of various forms of credit, on a firmly committed and dependable basis, and reduced use of gold in settlement of international payments. Since central bank cooperation has not succeeded in bringing this about, the Government should promptly adopt a new approach to achieve the needed strengthening of the system. This can be accompanied by measures which the United States can itself take to reduce the present attractiveness of gold and increase the dollar's attractiveness as an international asset. We can readily create a situation in which foreign central banks and

governments will be required by immediate and obvious self-interest to participate in a strengthened monetary system.

In a fundamental sense, the dollar is not merely as good as gold; it is much better than gold. It is only the willingness of the United States to buy gold in unlimited amounts at \$35 an ounce which keeps gold as good as the dollar. So long as we stand ready to convert gold into dollars without limit at \$35 an ounce, the holding of gold becomes a safe and cheap method of insuring against, or profiting from dollar devaluation. The convertibility of gold into dollars is universally taken for granted; it is the ability of the United States to keep converting dollars into gold which is questioned. Gold's special attraction both to foreign central banks and monetary authorities and to private hoarders and speculators depends upon this. If convertibility of gold into dollars were convincingly limited, gold would lose its attraction to central banks and to private hoarders and speculators. Dollars would become at once the preferred liquid asset.

It should be stressed that although the Government is completely committed to defending the dollar, it is not committed in comparable degree to the defense of gold.

The special and predominant position of the dollar as international money is not an artificial contrivance; it arises naturally and inevitably from the relative weight of the United States in the world economy and from this country's role in world finance and trade. A large part of world trade, including trade between third countries as well as U.S. trade, is transacted in dollars. The United States is, by a wide margin, the world's chief international lender and this country's very large net creditor position on both private and government account keeps growing year by year. During the past half century almost all foreign currencies have undergone successive depreciation against the dollar and the dollar has shown by far the smallest loss of purchasing power of any major currency.

Under these conditions, it should not be surprising that despite the unfavorable climate of speculative attitudes regarding the dollar during recent years, private foreign demand for balances in the United States has continued to increase. From the end of 1960 to the end of 1964, these private balances increased from \$7 to \$10.6 billion. Although the U.S. Government apparently provided forward cover for a portion of these foreign-held dollars, the growth in world trade, in U.S. foreign trade and in U.S. short-term and long-term lending abroad necessitated an increase in foreign holding of dollars for transactions purposes alone. Such growth is a normal feature of an expanding world economy. Owing to the unfavorable climate of speculative attitudes, private foreign balances in this country are undoubtedly at a subnormal level in relation to ordinary requirements. Although they would be temporarily reduced from their present level during a speculative dollar crisis, they could not readily be maintained at the reduced level for any sustained period.

In its origins, the use of the dollar as a reserve currency arose from causes broadly similar to those which have induced the growth of private foreign balances, and with a strengthened international monetary mechanism, the dollar would be generally preferred to gold as an international reserve asset. It should not be assumed that even under today's conditions, all foreign official balances here seek conversion

into gold. A large part of the foreign trade of Canada, Japan, and Latin America is with the United States and they depend heavily upon the United States for external financing, both long and short term. Countries such as these can be expected to hold a substantial fraction of their reserves in dollars. Nevertheless, the growing preference for gold as a reserve asset is undeniable.

Despite this preference, it is gold rather than the dollar whose use as international money is artificial and contrived. The resulting and quite unnecessary tyranny of gold is increasingly preventing the dollar from performing fully and effectively its appropriate role as international money. Further worsening of this situation will have highly adverse economic consequences, here as well as abroad. We were mistaken from the beginning in regarding the defense of the dollar as a balance-of-payments problem. As conventionally defined, a balance-of-payments deficit means nothing more nor less than an increase in foreign short-term liabilities without offsetting gold inflow. As was previously pointed out, annual deficits of perhaps \$2 billion would be normal under a healthily functioning international monetary system; less than this over a prolonged period would have undesirable deflationary effects on the world economy. Substantial swings in the balance of international payments extending over periods of several years should be expected, however, and it would be undesirable to eliminate them. Deficits of \$3 or \$4 billion for a few years are trivial by any fundamentally meaningful criterion for an economy the size of the United States; it is only in relation to gold that the deficits have not been trivial. In treating the problem as a balance-of-payments problem, we have not, in fact, been defending the dollar. Instead, we have been engaged in attempting to defend the contrived role of gold as international money at the expense of the dollar.

The real problem is and has been one of dethroning gold by building a strong international monetary mechanism resting on credit money rather than gold. Because of the dollar's inherently special position as a world currency, the United States can bring about this change through its own action without depending upon international agreement in advance. In principle, there are two methods of doing this. One method would be to discontinue selling gold at a fixed price. Although the dollar would initially depreciate, the unwillingness of other governments to experience an appreciation of their own currencies against the dollar would quickly induce them to buy and hold dollars as the only available means of halting such an appreciation and the dollar, would then, by force of necessity, become the dominant form of international reserve money. This course of action, however, would violate our pledge to sell gold at \$35 an ounce. The other method of subordinating gold to the dollar is to deprive gold of its present unlimited convertibility into dollars. This is the action which I recommend. The specific steps to carry out this recommended change are outlined below.

Announcement of future limitations on U.S. gold purchases would not immediately be convincing if made at a time when this country is losing gold. As a preparatory step, therefore, it is necessary to terminate the gold drain quickly by inducing prompt conversion into gold of that portion of dollar reserves which foreign central banks now contemplate liquidating. In order to expedite liquidation of this over-

hang, the Government should inform foreign governments and central banks that (1) we welcome the continued use of the dollar as a reserve currency by governments and central banks which have decided, as a matter of settled policy, that they wish to hold a reasonably stable fraction of their reserves in this form, but that (2) the U.S. balance-of-payments position has reached a point where the Government now invites immediate withdrawal of dollar reserves previously accumulated in excess of desired amounts. It should also be stated that dollar bloc countries; i.e., countries which hold the major portion of their reserves in dollars and the sterling area, would be exempted from capital movement controls except to the extent necessary to forestall substantial indirect leakage of U.S. capital to third countries. Finally, the interest equalization tax should also be lifted for all dollar bloc countries. Japan, for example, would be exempted from application of the tax.

This step would involve a substantial, once-and-for-all gold loss. It would be far less disturbing, however, and less likely to snowball, than the slow, prolonged drain which is now in process. An outsider lacks the confidential information on which to base an estimate of the size of the official withdrawals which the request for immediate conversions would induce. At a guess, however, the loss would be less than half of the \$12 billion held here by foreign central banks and monetary authorities. Once the withdrawals have been completed, the strength of the present balance-of-payments position should be reflected in excess market demand for dollars and a tendency toward gold inflow.

Liquidation of the overhang of reluctantly held dollars would have been somewhat easier if Federal Reserve statutory reserve requirements, instead of merely being reduced, had been eliminated. However, both former Secretary Dillon and Chairman Martin stated that the reduction in requirements was designed to symbolize and underscore our willingness to regard the whole gold stock as available for international payments. Since the Federal Reserve has power to suspend reserve requirements, no major difficulty is presented in making sufficient gold available. Legislation to eliminate the requirements can afterward be obtained.

If market reaction to the withdrawal of official funds should produce a wave of private speculation against the dollar, existing swap credits, IMF drawings, and our remaining gold holdings would be much more than sufficient to overcome any speculative attack. Moreover, present controls on U.S. capital outflow would limit the size and duration of a speculative attack by (1) curbing any possible domestic speculation against the dollar, and (2) curbing foreign short selling by making it difficult for foreigners to borrow dollars. Private foreign balances in the United States are already low in relation to normal transactions needs and a considerable proportion are committed through forward sales; although private foreign balances could be reduced in the event of a speculative attack, the reduction would be temporary and limited. Thus, private speculation if it occurred, would be manageable in amount and of rather brief duration.

The changes in gold buying policy which I propose should be promulgated upon completion of the preparatory step are outlined in somewhat detailed and specific terms in the paragraphs which follow. It need hardly be added that some of these details are for illustrative purposes only.

1. Limitations on gold purchases from central banks and monetary authorities.

(a) *Dollar bloc countries and less developed countries*

No limitations would be imposed on the eligibility for purchase by the United States at \$35 an ounce of gold reserves owned by these central banks on the date of promulgation of the new U.S. rules. Any gold subsequently acquired would not be eligible for purchase by the United States.

(b) *Great Britain*

Britain's position as a financial and reserve currency center justifies special arrangements. The United States should indicate readiness to make a reciprocal gold purchase plus credit agreement with Great Britain, along the following lines:

(1) The United States would stand ready to purchase gold at \$35 an ounce in an amount equal to British central gold reserves on the date of promulgation of the gold buying rules. Britain would agree to sell gold only when necessary for balance-of-payments reasons. Any gold in excess of the amount held on the promulgation date would be ineligible for purchase by the United States.

(2) Britain would stand ready to buy an equal amount of gold from the United States, when necessary for balance-of-payments reasons.

(3) Reciprocal credits (swaps) without specified maturity and covered by an exchange value guarantee would be established in an amount equal to twice the commitment with respect to gold transactions. It would be mutually agreed that drawings under the credit would be geared to gold sales in the ratio of two units of credit utilization to one of gold sales.

(c) *Other countries (excluding Communist bloc)*

The United States should indicate readiness to make reciprocal gold purchase plus credit agreements with other countries following the same form as the proposed agreement with Britain but with more restrictive provisions with respect to gold transactions.

The United States would stand ready to purchase gold at \$35 an ounce in an amount equal to (1) all net acquisition of gold by the other party to the agreement between the date of the U.S. request to hasten conversion of unwanted dollar reserves and the date of promulgation of the new gold purchase rules plus (2) one-third of gold reserves held prior to the U.S. invitation. We would agree to purchase gold only to provide dollars currently needed for balance-of-payments reasons. Any gold subsequently acquired otherwise than through purchase from the United States under this reciprocal agreement and two-thirds of the gold held prior to the U.S. invitation to withdraw undesired dollar reserves would be ineligible for U.S. purchase.

The other party would make a reciprocal commitment to purchase gold from the United States in equal amount. The reciprocal credit would be twice the other party's gold holdings at the date of the U.S. invitation to withdraw unwanted dollar reserves. Drawings would be geared to gold sales in the ratio equal to the ratio of the total credit commitment to the total gold commitment.

(d) IMF

The agreements with foreign governments would include provisions to assure that gold ineligible for sale to the United States did not reach us indirectly through sale to the IMF.

2. Outside gold.

Under the above proposals, gold would be transferred among central banks and monetary authorities at its monetary value but in restricted amounts, and the outside market would be left, at least initially, to find its own level since central banks would not be willing to buy gold ineligible for conversion into dollars. There is no basis for guessing at what level the outside market would settle once the support provided by official purchases was withdrawn.

Gold output (excluding the Communist bloc) amounted to \$1.4 billion in 1964. Russian sales during the first 10 months of the year were estimated at \$350 million. Thus, new gold supplies were in the neighborhood of \$1.8 billion, of which roughly \$1 billion was absorbed by nonmonetary uses—industrial, and hoarding and speculation. Licensed industrial users in the United States consumed about \$100 million; world consumption, apart from speculative hoards, can perhaps be placed at about three times the U.S. figure, leaving roughly \$700 million as the estimated addition to speculative hoards. Since the end of World War II perhaps \$6 to \$9 billion has been absorbed by speculation and hoarding, most of it in the past 6 years.

The proposals for limitation of gold buying offset by reciprocal credit arrangements involve only a moderate net expansion in international liquidity. The only source of net expansion is the proposed reciprocal credit between the United States and Britain. If international agreement can be obtained, it would probably be desirable to authorize the IMF to purchase in the depressed outside market and monetize gold in the amount of about \$500 million monetary value annually. The profit realized by the IMF in marking up this gold to its monetary value could well be donated to the International Bank for investment in less developed countries. Regular monetization of some small amount of outside gold would meet a portion of the need for secular expansion of international liquidity. This need could also be met, if necessary, by increasing reciprocal credits or by making eligible for international settlements a small annual percentage of the initially ineligible central bank holdings. Finally, with the dollar's position duly restored as the preferred type of international liquid asset, the long-term need for expansion of international reserves could safely be met through the creation of dollar balances by means of U.S. capital outflow. Determination of the most appropriate methods of regulating the long-term growth of international liquidity to conform to the requirements of an expanding world economy can well be deferred until the system here proposed has been fully established. In any event, it will not be difficult to avoid the extreme arbitrariness and the vagaries of the present system.

The measures proposed above, if adopted, will yield, I believe, a number of highly valuable results. Confidence in the dollar will be fully restored and undesirable constraints on U.S. domestic and foreign policies will be removed. A strong and durable international monetary mechanism will be established, using dollar balances as the

preferred form of central bank reserves and of private international liquidity. This will be a dollar reserve system without the critical weaknesses of the present system. The central role of the United States as banker and financial intermediary and the general preference for dollars as a store of liquidity will enable interest rates in the United States to be maintained well below European rates. Voluntary controls on U.S. capital outflow, the interest equalization tax, the tying of foreign aid and the Government's "Buy American" program will cease to be necessary and can be ended. The reciprocal credit with Britain which I have proposed should secure the pound's link to the dollar and give time for working through present difficulties.

Admittedly, the program which I have proposed is somewhat bold. Although it will, of course, be hotly opposed as both utopian and evil by those on whom gold casts a mystical spell, nevertheless, the monetary history of the past several centuries may be epitomized as the progressive substitution of credit money for commodity money and these proposals would represent a further step along this path.

If this program is judged to have merit, it can and should be carried into effect quickly so that it may be completed before the British credit comes up for further renewal. If General de Gaulle, by posing the issue with absolute starkness, precipitates a fundamental reconstruction of the international monetary system substituting the dollar for gold as the preferred reserve asset, we will owe him our thanks. Whether or not a program of action along the lines which I have proposed is put into effect, there can now be little doubt that the crisis of the international monetary system which we have been experiencing for the past half dozen years will culminate in the dethronement of gold and its replacement by the dollar. The only question is whether this transition will be effected deliberately, or by the compulsion of events and with considerable injury to the free world economy. This country's international financial position gives it the power to decide whether to carry out the transition deliberately or await the compulsion of events.

Under a strengthened international monetary system based on the dollar, the financial power of the United States will be greatly increased. It will be exceedingly important at this stage that we refrain to the greatest extent possible from using this power unilaterally, and that we develop, through the IMF and OECD, settled habits of multilateral policy consultation and determination.

General de Gaulle's effort to use international monetary policy as a major instrument of power politics is almost laughable. In their effectiveness the weapons at his disposal are on a par with his independent nuclear deterrent. His use of the monetary weapon can injure the French economy and the free world economy for a time, but it cannot succeed in its intended objective of downgrading the position of the dollar. On the contrary, it is hastening the predominance of the dollar. If international cooperation in monetary matters had been possible, the present crisis of the international monetary system might have been solved through agreement to establish a multilateral system leaning less heavily upon the dollar. French intransigence, however, has been a major factor foreclosing this outcome, and there are now no remaining alternatives to a world dollar standard. It will then become necessary for this country to operate the system in

such a fashion as gradually to subdue the feelings of frustration which this outcome will cause in some quarters abroad.

This interpretation of the present international monetary confrontation as one in which the French Government is unwittingly defending the dollar while the U.S. Government is unwittingly defending gold will perhaps be dismissed as carrying paradox to the point of absurdity. But the crisis of the international monetary system has generated many such paradoxes. While the U.S. Government has felt it necessary, in its efforts to restore confidence in the dollar, to keep asserting its unequivocal commitment to the dollar's defense, it is also generally acknowledged that the dollar could not be successfully devalued against foreign currencies even if this country so desired, because other governments simply would not tolerate the resulting appreciation of their currencies against the dollar. Must one therefore conclude that the dollar's present external value is at the same time difficult to maintain and impossible to change?

It is paradoxical that the country whose currency has shown the greatest strength during recent years is one which has been running a larger import balance in goods and services, in relation to its gross national product, than most underdeveloped countries receiving foreign aid; it has been borrowing short not merely to lend long but also to finance current imports, and it has continued to experience gold inflow despite efforts to retard the further growth of its short-term foreign liabilities by such measures as nonpayment of interest on foreign deposits. The country is Switzerland.

In the later years of the Marshall plan the U.S. balance of payments was in a position of so-called deficit and Western Europe in surplus. European voices were not raised to point out that this country was merely giving back what it was borrowing at short term nor to demand that aid should be cut. It is ironic, although not surprising, that such demands are being made when the aid is going to underdeveloped countries. The implication is that foreign official holders of dollars should be given veto power over U.S. policies. Although the United States would reject any such explicit demand, mistaken preoccupation with the balance of payments has been one factor leading us to restrict aid and curtail its real amount through tying.

It is paradoxical that not only laymen but also many economists regard a steadily widening gap between this country's short-term foreign liabilities and its gold holdings as a bad thing, as if the principle of fractional reserve banking were unheard of, while they also acknowledge that if the gap stops widening, through elimination of the U.S. deficit, deflationary strains which would finally become unendurable would be imposed on the world economy. Must we conclude that a U.S. deficit is both bad and essential to a healthy world economy?

This catalog of current paradoxes could be boringly expanded. It is strange that just as we have slowly emancipated ourselves from irrational preconceptions about fiscal deficits, we have come under the spell of irrationalities about balance-of-payments deficits. All the paradoxes cited above, and many others, are resolved once it is recognized that the United States performs an essential banking and deposit creation role for the rest of the world, that the existing international monetary system is inhibiting effective performance of this

role and that the problem can be solved not by abandoning the role, i.e., eliminating the deficit, but only by modifying the system. Looking beyond the present crisis of the system, it is not the international role of the dollar but the role of gold which is in jeopardy. The course of action which I have recommended would, if successful, preserve for gold a limited role in settling international payments. Thus the recommendation, if seemingly bold, would be conservative in final result.

APRIL 27, 1965.

Mr. ROBERT V. ROOSA,
Brown Bros., Harriman & Co.,
New York, N.Y.

DEAR BOB: I am enclosing a copy of a memorandum containing a proposal for strengthening and giving needed flexibility to the international monetary system which I sent early this month to Secretary Fowler, with copies to Kermit Gordon and Gardner Ackley.

The proposal provides a means of putting into effect John Williams' key currency approach of a generation ago. If the Government had accepted this approach at that time instead of the White plan, we would surely have avoided the difficulties which have beset us since 1959, and the British, freed of recurrent sterling crises, might have been able to share more adequately in Western Europe's vigorous economic growth. Finally, the financing needs of the rest of the world might have met with less dependence on U.S. Government aid.

The means which I propose for transforming the present, vulnerable gold exchange standard into a truly strong dollar-sterling standard is a change in the U.S. gold buying policy. Under my proposal, the amount of gold which we would stand ready to buy at \$35 an ounce would be limited to one-third of the present foreign official holdings, with an offsetting introduction of credit to complement gold as a source of dollars, in the ratio of two of credit to one of gold. Apart from favored treatment accorded to the limited amounts of gold held by LDC's and dollar bloc countries, the only other exception to the one-third limitation would be Britain, the purpose of this exception being to underwrite securely the pound-dollar peg. The proposal amounts to a partial demonetization of gold, and although gold would continue to be used in strictly rationed amounts at its present monetary value in settling international payments, its free market price would fall. Incidentally, we would offer to enter into the same reciprocal gold plus credit arrangement with the U.S.S.R. and Eastern Europe as Western European countries.

I did not put forward this proposal earlier because the announcement of such a change in gold buying policy would not have carried conviction while the dollar was weak. The dollar's only remaining source of weakness, however, is the overhang of reluctantly held balances in the hands of European central banks, and I have proposed that we should invite the remaining reluctant official holders to convert into gold before we adopt the new gold plus credit formula. The preparatory step would underscore our own confidence in the dollar's underlying strength, and the subsequent announcement of restrictions on gold purchases would produce, I am convinced, a dramatic and lasting shift in present, perverse asset preferences, moving them away

from gold to dollars and pounds. The reserve currency system would cease to be, as it has been, a system good only for "fair weather."

I suspect that you will be sympathetic to the objectives of my proposal and I hope that you will also approve the means. I have shared the view which you have repeatedly emphasized that the international monetary system can be constructed only by building upon the present system and correcting its weaknesses—not by tearing it down in favor of some abstract blueprint. It would be no coincidence if we both favored the key currency approach, since we received our initial indoctrination in this subject from the same source—John Williams.

The Triffinites and the Rueffites are at one in desiring to eliminate the weaknesses of the present gold exchange standard by abolishing it. The Triffinites are naive in believing that European central banks, which are reluctant to keep accumulating dollars instead of gold, will be satisfied by any scheme which proposes to fund their existing liquid dollar claims into long-term obligations and which asks them to accept further accretions to reserves in the form of book credits with the IMF.

The Rueffites, and the only slightly less extreme CMUites, are dangerously naive in another respect. They believe that if they could succeed in demoting the international financial role of the United States—and of Britain—to a level comparable to that of France and the other EEC countries, the result would be beneficial to France and Continental Western Europe. Nothing could be more completely wrong. The cost in terms of reduced earnings of New York and London banks would be slight indeed in comparison with the much greater cost in terms of blockage of European trade which would be produced by the withdrawal of the essential financing facilities which these centers provide. For the United States, the loss of bank earnings would be a small thing; for Continental Western Europe, the loss of the dollar financing facilities would be a disaster. Europe is getting only a foretaste of this today, through our voluntary capital controls.

It is an impressive fact that the EEC has made virtually no progress in financial "harmonization," in integration of capital markets or in the development of arrangements for mutual financial support to bridge the payments difficulties of individual members, and that even the modest recommendations made by its secretariat remain unheeded. Moreover, apart from the Dutch banks, whose resources are limited in relation to the total requirements, the prevailing banking traditions and practices in continental Western Europe are primarily domestically oriented and fail to furnish the financing facilities which foreign trade requires.

This gap in Europe's financial structure used to be filled by sterling and sterling credits before World War II. Since the restoration of convertibility at the end of 1958, the dollar has largely replaced sterling in performing this role. The increasing transactions needs for dollars resulting from use of dollars as the unit of account, medium of exchange and standard of deferred payment in intra-European trade and finance, and in Europe's transactions with the outside world, goes far to explain the substantial growth in private foreign balances in the United States and the even more striking growth of Euro-dollars deposits in the face of a predominantly unfavorable climate of speculative attitudes regarding the dollar. Moreover, it is impressive that

after the interest equalization tax was announced, most new security issues by European borrowers for sale to other Europeans were denominated in dollars and that New York investment banks were asked to participate prominently in the underwriting. Last of all, the unreflecting haste with which the European Payments Union was dropped simultaneously with the restoration of current account convertibility at the end of 1958 is evidence of the absence, in continental Western Europe, of the kind of banking and financial tradition upon which a viable international system must rest. It was indeed fortunate for the initial success of the EEC that it was launched at a time when all its members enjoyed substantial payments "surpluses," thanks to the U.S. "deficit."

If France and continental Western Europe find distasteful the condition of financial dependence implicit in present arrangements—and such an attitude is understandable—the solution, surely is not the self-destructive course of forcing us to withdraw the financing facilities upon which they so heavily depend and which they have, until recently, taken for granted. It is, rather, to transform their own financial institutions, markets, and practices so that the role of financial intermediary formerly performed largely through sterling and now chiefly through the dollar can be more largely performed by themselves. But I have the impression that only a few members of the European financial community perceive this, and even after it becomes more widely perceived, the necessary transformation of institutions and habits will still be a long, slow process. Meanwhile, Western Europe's own interests will be best served if they reconcile themselves to continued use of dollars and sterling and stop talking about "reciprocity."

I think that our only point of difference in the past has been on the question whether the necessary strengthening of the international monetary system could be achieved by patient and tactful negotiation with European central banks. These negotiations did produce the critically important result of containing speculative dollar crises and they greatly helped to hold down the gold drain, but I have thought that it was overoptimistic to believe that the new financing devices which you took a leading role in working out could provide the basis for a longer range reconstruction of the system.

The reason why these arrangements cannot, in my view, be quickly enlarged and developed into a flexible international monetary mechanism is the persistence in the minds of European central bankers of an orthodox but obsolete view about the way a fixed exchange rate system must work. I am disposed to place the blame for the persistence of this outworn orthodoxy on the economists, rather than on the central bankers themselves.

According to the orthodox theory of the gold standard, the balance of payments in goods and services must adjust to the capital movement, if equilibrium is to be maintained. Although, when disequilibrium appears, the provision of some financing by surplus countries is admitted to be permissible to facilitate transition to a new equilibrium, such financing, it is held, must be in very limited amounts and must be short term, lest compensatory financing degenerate into a device for merely perpetuating the disequilibrium by delaying needed adjustments.

The traditional theory fails to take into account some of the essential functions performed by international capital movements; as a corollary, it implicitly denies the special need for, and the requirement for effective operation of a world financial center. I refer, of course, to Britain before World War I, Britain and the United States in the interwar years, and predominantly the United States since World War II. Capital outflow from the financial center serves not merely to transfer real resources of other countries by financing the financial center's current account surplus but also serves to supply liquid balances to the rest of the world in the growing amounts needed for the healthy expansion of world trade. It is this second function which is ignored in orthodox theory and by European central bankers. The flow of capital between the financial center and the rest of the world is a two-way flow—a large outflow of capital in the form of direct investment, long-term loans and short-term credits and a smaller inflow chiefly through foreign accumulation of liquid balances and marketable securities.

It is quite wrong to say that under an adequately functioning reserve currency standard the supply of liquidity to the rest of the world would depend upon the size of the "deficit" in the balance of payments of the financial center. The opposite would be the case. The size of the "deficit" would depend upon the rest of the world's demand for additional liquidity, since subject only to the limits set by the financial market's estimate of the borrower's credit worthiness and his future debt servicing capacity, other countries would have access to a flexible source of liquidity adjustable to their needs.

The only trouble is that the workability of such a system depends upon the willingness of the rest of the world to regard liquid claims against the financial center as, for all practical purposes, the best form of liquidity. Gold may remain symbolically in the background so long as, in practice, it is not preferred. Recent difficulties have been due to the fact that this essential state of practical preferences has not prevailed, especially among continental European central banks. It is foolish to assert that a reserve currency system is unfair because it exempts the reserve center from the balance of payments discipline which other countries must accept; more important is the fact that while other countries are able to borrow from the reserve center in amounts limited only by their general credit standing and estimated debt servicing capacity, the reserve center can negotiate credits abroad only with the greatest difficulty—since a banker is not supposed to seek loans from his clients. Thus, the lack of reciprocity in the reserve currency system works both ways. The discipline to which other countries are subject is not what is postulated by orthodox gold standard theory because it is nullified by ample access to external finance from the reserve center; the only discipline is that of credit standing. The reserve center's access to external finance has a different basis; it can only with difficulty exceed the rest of the world's desire to accumulate liquid claims against the reserve center. Consequently, when gold takes the place of the reserve currency as the most desired form of liquidity, this pressure, misnamed discipline, becomes not only excessive but finally intolerable. With the system headed for breakdown, the financial center, to avert this climax, must restrict its activ-

ities as banker and financial intermediary, as we have now done through the interest equalization tax and voluntary controls on capital outflow.

These controls provide the opportunity for basic strengthening of the system. If the opportunity is not seized, and if, instead, present controls are retained or made compulsory, they will be found to have gravely injurious economic consequences for other countries.

The voluntary capital controls represent a temporary effort to limit capital outflow to the financing of real transfer through the current account surplus and to suppress the fulfillment of the second function—the provision of the liquid assets needed by a growing world economy. Given the unwillingness of European central banks to accept additional liquidity, in financial form, we had little choice although it is regrettable that the consequences of this choking off of needed growth in liquidity are being inflicted on innocent bystanders, such as Japan and Australia.

My pessimism regarding the possibility of solving the problem through negotiations with European central banks and finance ministries is due to my belief that the principles of gold standard orthodoxy are too deeply rooted in their minds to be quickly dislodged. I believe that this adherence to a theory which is not only obsolete today, but didn't work in the 19th century heyday of the gold standard (really, a sterling standard), is the main stumbling block to international agreement. This is the chief obstacle rather than either any mystical, irrational yearning for gold or power politics. In the case of Spain, and possibly the French monetary authorities in some degree, gold may have a somewhat irrational appeal, but this is scarcely true for the financial authorities in other countries. Moreover, political considerations, although they have cut both ways, have operated, on balance, to give official support to the dollar. Most European central banks have kept more of their reserves in dollars, and have provided larger credit facilities than they would have done if guided strictly by orthodox European central banking doctrine. They have done so partly for reasons of political friendship and partly to help avert or contain crises.

If this judgment is correct, negotiation to achieve substantial improvements seems unpromising and action of the general type which I have proposed is the only method of reconstructing in the near future a workable reserve currency system. If carried out, this proposal will enable us both to meet the financial needs of other countries and to relieve ourselves of the strains and difficulties which we have had to cope with for half a dozen years.

I wonder what you think of all this. Having just received an announcement from the Council on Foreign Relations that you will be giving three Elihu Root lectures on this subject next month, I was sorry to note that none of them fell on the days when I shall be in New York, but I greatly look forward to reading your lectures and hope that you will send me the reprints.

Cordial greetings.

Yours sincerely,

EMILE DESPRES.

THE BROOKINGS INSTITUTION,
Washington, D.C., July 19, 1965.

HON. JACOB K. JAVITS,
*Senate Office Building,
Washington, D.C.*

DEAR SENATOR JAVITS: I am writing in response to your request of June 22 for my opinion on the general idea of modifying U.S. gold-buying policy or on any specific plan for doing so.

Various advocates of such plans have stated the purposes of their proposals differently, although it is possible that, if pressed, they would all prove to have the same ultimate purposes in mind. Considering only the purposes stated by the proponents, we find that the minority members of the Joint Economic Committee, in their report of 1962 cited in your letter, intended to "help stem the outflow of gold." Professor Machlup proposed gradual decreases in the price at which the United States purchases gold in order to "make it perfectly clear all around that gold hoarders could lose money," the obvious ultimate purpose being to cut hoarding of gold. He referred to his proposal as an "expedient makeshift" in case another crisis of confidence about the future of the dollar occurs before the gold exchange standard is either reinforced or replaced by another system. (See his Princeton Special Paper No. 3, "Plans for the Reform of the International Monetary System," revised March 1964, p. 70.) The plan of Prof. Emile Despres, in contrast, is intended as a permanent new international monetary system; the proposal to limit U.S. purchases of gold, while the lynchpin of the plan, is only one of its elements. This plan is more ambitious, more fully worked out, and more sophisticated than other plans involving changes in the U.S. gold-purchasing policy. So far as I know, it is the only one that leaves the access of foreign countries to dollars, and thus international reserves, unimpaired. For these reasons—and also because I have studied the Despres plan more intensively than the others—I shall confine my comments to it.

Let me say at the outset, first, that I believe it merits very serious consideration. Second, I do not regard my own consideration of it as closed, so that the conclusions of this letter are subject to revision.

The purpose of the Despres plan, broadly stated, is to strengthen and give needed flexibility to the international monetary system while continuing to use the reserve-currency system as a base. (In this, it may be contrasted with the reform plans proposed by both Prof. Robert Triffin and Prof. Jacques Rueff, which differ greatly from each other but have in common that they would end the use of national currencies as reserves.) It is designed to permit the United States and the United Kingdom to continue providing financial facilities essential to the continued expansion of international trade, including that of continental European countries as well as of the United States and the United Kingdom, and at the same time to relieve reserve-currency countries of strains and difficulties which the present system may impose on them not only when they are in deficit for fundamental balance-of-payments reasons but also when their "deficits" result merely from performing the useful function of providing liquidity which other countries desire. The proposal would give this needed flexibility and strength by eliminating unlimited competition between foreign currency reserves, which are "natural" assets because

they are useful and desired in themselves, and gold, which, in Professor Despres' view, is not.

I shall not here describe all the specific provisions of the plan, since you presumably already have a copy of Professor Despres' memorandum explaining it. Suffice it to say that it involves combining a partial demonetization of gold with reciprocal credit agreements between the United States and other advanced countries. The credit agreements would offset the effect that the partial demonetization of gold would have on the international liquidity of the partner country—and, in the case of the United Kingdom, a special arrangement would more than offset it.

On grounds of substance, the Despres plan merits, at the least, serious discussion and consideration. My own present conclusions are that it meets most of the economic criteria of a good monetary system as well as the present system or other proposals for reform and it meets some of them better. I am not sure it meets any of them less well. I suspect that the economic arguments against it arise mainly from its novelty and the difficulty of breaking old habits of thought. My present uncertainties about it arise from political considerations about the need for meeting the present desires of other countries, and the fact that a mistake might be irreversible. I find these considerations difficult to appraise. It should be noted, however, that the U.S. Government, in a number of other areas of foreign policy, has recently decided to exercise the power of the United States unilaterally for what it believes to be the common good.

Permit me to elaborate on the economic aspects of the plan.

Despres plan in relation to criteria of a good monetary system

A good monetary system should do a number of things, which I have spelled out at greater length elsewhere. (See "Does the International Monetary System Need Reform?" in *Money in the International Order*, edited by J. Carter Murphy, Southern Methodist University Press, 1964, a reprint of which is enclosed.) First, it should provide a generally acceptable medium of exchange in order to permit maximum freedom of choice in international transactions. If one regards integration of capital markets as desirable, this criterion implies fixed exchange rates between currencies.

Second, it should provide liquidity adequate to finance temporary differences between receipts and expenditures while necessary adjustments in payments are taking place, i.e., elimination of undesirable payments deficits and surpluses. In this context liquidity includes not only officially held reserves (liquid assets in generally acceptable forms) but also readily available borrowing facilities. "Adequate" liquidity implies that the available international liquidity should change in a way that is rationally related to needs, rather than fluctuate haphazardly, as it now does.

Third, this implies that the system should not induce or permit alterations in the total amount of reserves from occurring merely as a result of changes in the form in which countries hold their reserves; it should either eliminate drastic alterations in the composition of reserves or offset any inflationary and deflationary effects of such alterations. I have in mind, for example, the need to avoid contraction when reserves held in national currencies are converted into gold. It should go without saying that a good monetary system ought not,

through its own operation, create a need for balance-of-payments adjustments by its own failure to offset the effects of such conversions. Finally, it should perform these functions without frustrating the abilities of countries to use their resources of capital and labor fully.

The Despres plan would limit, although not eliminate, the role of gold in the monetary system, and put the participating world basically on a dollar standard. Despite some expressions of contrary opinion, the dollar is a generally acceptable medium of exchange and store of value. It is used very widely in international payments, not only in transactions between the United States and other countries but in transactions to which the United States is not a partner. It has proved to be a good store of value, as well as medium of exchange. That it is still so regarded is shown by the voluntary expansion of private foreign holdings of liquid dollar assets, amounting to \$1.7 billion during 1964. The decrease in willingness to accumulate or maintain liquid dollar holdings, which has given rise to the widespread belief that the dollar's acceptability has been impaired, is confined to some official monetary authorities. Their behavior, moreover, does not reflect a fear of the dollar. It is largely an act of policy on the part of the country or countries that initiated these conversions, designed to enforce on the United States a particular mode of behavior which they believe is to their national interest.

Under the Despres plan, exchange rates among the participating countries would be fixed. International settlements would be made in both gold and dollars as at present, but gold would play a smaller role and dollars a larger one. When the United States was in surplus, other countries would have the same access to dollars that they have now. Under the reciprocal agreements envisaged in the proposal, a portion of gold held by some countries prior to the announcement of the new U.S. gold-buying policy could not be sold to the United States, but this portion would be replaced by access to dollar credits. Prior to the signing of these reciprocal agreements, the United States would buy the foreign currencies of deficit countries which did not want to deplete their dollar holdings or whose holdings were insufficient. (The access of the United Kingdom to dollars would be increased because the United States would stand ready to purchase all the gold in British central gold reserves at the time of the change in U.S. gold-buying rules and would also enter into a reciprocal credit arrangement with the United Kingdom involving an amount equal to twice the commitment with respect to gold transactions.) When the United States was in deficit, it would sell gold or its foreign currency holdings and use its rights under existing and proposed reciprocal credit arrangements.

At present, competition between gold and dollars as a reserve asset permits the total volume of international reserves to be reduced. This happens if a country decides to convert into gold the reserves that it holds in the form of dollars. It also happens if reserves shift from countries holding their reserves largely in dollars to countries holding their reserves largely in gold. Such shifts cut total reserves, just as conversion of deposits into currency in a fractional-reserve banking system cuts the domestic money supply. In that respect, the present international monetary system is comparable to our national banking system before the days of the Federal Reserve when financial difficulties in the interior of the country could cause a run on the New York

clearinghouse banks and they had no access to a central bank. It imposes pressure for contraction when there is no economic need for it. The Despres plan proposes to remove this element of instability in the present international monetary system by strengthening the preference for holding dollars. Its underlying assumption is that the limitation of the U.S. willingness to buy gold at \$35 an ounce will decrease the attractiveness of gold at that price and increase the attractiveness of dollars as an international asset, both for making settlements and storing wealth. Underlying this assumption is the fact that, owing to the power and importance of the U.S. economy, the dollar has a natural, rather than a merely artificial, strength, and the belief that, fundamentally, the desire to hold gold at \$35 an ounce is artificially maintained by the present U.S. gold-buying policy. Thus, the willingness of the United States to buy gold without limit at this price strengthens the one liquid asset which is the dollar's chief competitor and thereby weakens the dollar's strength in performing that function. If this assumption is correct, the proposal would strengthen the dollar and the international monetary mechanism.

If confidence in the dollar were thus strengthened, some constraints on otherwise desirable U.S. policies certainly could be removed. This is true not only of domestic policies, which have been and are now being constrained by the international financial problem, but also of our foreign economic policies. It would be possible to end present controls on the balance of payments, including the voluntary control of private capital outflow, the tying of foreign aid, the interest equalization tax, and our buy-American program for Government purchases, insofar as they are based on balance-of-payments considerations.

The correctness of the assumption that the asset preference of foreign holders would shift from gold to dollars, at their present price ratios, is the major economic question raised by the plan. I defer dealing with this question until later.

The plan provides a number of possible ways of adding to available international liquidity. First, the proposed reciprocal credit between the United States and the United Kingdom is the only one built into the plan automatically. It would give the United Kingdom time to overcome its balance-of-payments difficulties. Second, the International Monetary Fund could be authorized to purchase gold in the outside market. Presumably it would be able to do so under the Despres plan at a price well below \$35 an ounce; it could then monetize it at \$35 an ounce and the seigniorage would constitute an additional source of reserves when the Fund was used. Third, it would be possible to increase the reciprocal credits with all countries or to increase the amount of gold eligible for international settlement above the amount that was made eligible when the plan first went into effect. Fourth, after the dollar's position as a preferred reserve asset was restored, dollar balances created by U.S. private capital outflow could provide an additional source of liquidity. These possibilities are all mentioned in Professor Despres' memorandum.

This system would eliminate the pressure for balance-of-payments adjustments on the part of reserve-currency countries in some situations where the present system imposes such pressure irrationally. In eliminating the need for adjustment in such situations, the Despres

plan involves a sacrifice of balance-of-payments "discipline" of a sort that it is well to be rid of.

So far as adjustment to true disequilibrium is concerned, deficits of other countries would be financed in part by the extension of private credit, so long as their credit standing was unimpaired, just as it can be under the present system. When their credit standing became impaired, the deficit countries would use their gold reserve and official credits, just as they do now, but in an agreed 1-to-2 ratio. There would still be some pressure on them to adjust. The United States would also be subject to pressure to make rationally needed adjustments, since it could lose gold when in deficit.

The ratio in which credit and gold would be used (or U.S. holdings of foreign exchange reduced) would permit more adjustments to be made more gradually. We have seen in recent years that, notwithstanding complaints about the failure of the United States to get rid of its deficit, it has gradually brought its basic payments into adjustment. The contribution of governmental policy measures to this adjustment has probably been relatively small. (On this point, see pp. 396-398 of my statement to the International Finance Subcommittee of the Senate Banking and Currency Committee on March 18, 1965, or p. 13-14 of the enclosed reprint of it, entitled "A New Look at the U.S. Balance of Payments.")

It is true that this adjustment has taken place more slowly than has conventionally been thought desirable or permissible. If one analyzes the reason for the conventional notion that adjustment should be rapid, however, one finds that it is based on requirements of the existing monetary system, which is assumed as a datum. It assumes its own conclusions. Having no foundation independent of the requirements imposed by the system itself, the reason is irrelevant to the question of the speed of adjustment appropriate under a revised system. (On this point, see p. 20 of my paper "Does the International Monetary System Need Reform?" which is enclosed. On the rational considerations affecting speed of adjustment, see the small volume called "International Monetary Arrangements: The Problem of Choice," edited by Machlup and Malkiel, pp. 43-53, reporting on the deliberations of an international study group.)

There is no rational objection to swings in the balance of a country's international payments extending over periods of several years and good reason, in some cases, not to force them to be completed in 1 or 2 years, as the conventional assumption requires. In any case, since under the Despres plan deficits would be accompanied by some loss of gold, the main difference from the existing system is that credit would play a large role and gold a smaller one than it has in some recent years. It is to be noted, moreover, that the degree to which deficits were financed by credit and gold losses on the part of the United States in recent years was entirely haphazard, gold having been the main component of our deficit financing in some years and official or private credit in others.

Effects on demand for gold

Despite its undoubted merits the Despres plan raises a number of questions, economic, legal, and political.

A major criticism of the Despres plan is that there is no certainty that the change in U.S. gold-buying policy would shift asset pref-

erences of foreign monetary authorities and private citizens from gold to dollars, and that the demand for gold might in fact rise, instead of falling, as Professor Despres assumes.

It should be noted that Professor Despres, being fully aware that the change in U.S. gold-buying policy might be ineffective if made when the United States is losing gold, proposes some preparatory steps which, in his opinion, would suffice to overcome this problem. First, he proposes that we make clear that we welcome continued use of the dollar as a reserve currency by countries that propose to hold a reasonably stable fraction of their reserves in this form. Second, he proposes that we invite the monetary authorities of other countries to convert promptly into gold any portion of dollar reserves which exceed the amounts they desire to hold. Third, he suggests exempting from control the flow of U.S. capital to the sterling area and to countries which hold the major portion of their reserves in dollars, except to the extent that controls are necessary to prevent capital from leaking through these countries to others. Finally, he would exempt all these "dollar-bloc" countries from the interest equalization tax. These inducements would increase the willingness, and in fact stimulate the desire, of many countries—including the United Kingdom, a major holder of gold—to hold a portion of their reserves in dollar balances.

I think this program of preparatory steps could be strengthened by several additions. One would be to eliminate the statutory requirement of gold reserves against Federal Reserve notes, a step which is desirable in any event and which Professor Despres is willing to leave to a later stage of his plan. This would tend to reduce fears about the adequacy of U.S. gold reserves. Another would be for the U.S. Treasury to purchase at least \$3 billion of foreign exchange of continental European countries, paying for it with gold. This would substitute a single large and controlled gold loss for a series of uncontrolled losses which might otherwise occur after the United States invites other countries to convert unwanted dollar holdings into gold. Finally, I would seek to arrange in advance with the United Kingdom and Canada to convert some of their present gold holdings into dollars to provide an offset to gold losses that we could expect when others act on our invitation to convert dollars into gold.

These preparatory steps would greatly reduce the net gold losses that would result from the invitation to convert dollars into gold and they would greatly increase the probability, if not assure, that the new gold-buying policy would change reserve asset preferences in favor of the dollar.

In terminating the gold drain quickly, such steps, in Professor Despres' opinion, would advance the date of the effect which he predicts would in any case occur eventually. But some critics have questioned that the demand for gold relative to dollars would ever fall. They regard this demand as entirely irrational and unpredictable. As one economist has said, when the sheep get in a panic, you cannot tell which way they will run. These critics apparently believe that if the demand for gold increased in the first stage of the policy, the initial speculative effects would give rise to further developments that would sustain the rise, so that the first speculative reaction would be self-justifying. Presumably they have in mind the possibility that an announcement such as Professor Despres proposes, instead of having

the effect he intends and expects, might have the opposite effect, causing great uncertainty in the rest of the world about what the United States would actually do and perhaps leading some people to conclude that in the end the United States would actually go back to buying gold at a price above \$35 an ounce.

My opinion on this point is that, provided one assumes that the United States embarks on the policy with firm determination to live with its decision, the criticism that the eventual effects of the Despres plan on the demand for gold at \$35 an ounce are unpredictable is quite incorrect. It either assumes that U.S. policy will vacillate in the face of initial confusion or of initial gold losses, or else it throws economic analysis completely to the winds. Considering first the eventual effect, even if speculative factors and the psychology of hoarders, official and private, are unpredictable, persistence in the policy would make fundamental factors prevail in the end. When a holder owning approximately one-third of the world's monetary stock and perhaps one-quarter of the world's total gold stock limits its previously unlimited willingness to buy gold while continuing its unlimited willingness to sell, the price of gold must fall sooner or later. So long as the U.S. Government embarked on this policy with clear and confident purpose, there would be nothing to cause an offsetting increase in the non-speculative demand of others for gold at \$35 an ounce. Any initial increase in demand would eventually be satisfied by U.S. sales. The speculative component of the demand would then diminish, leaving the market more than saturated at \$35 an ounce. The proposition that "anything could happen" might be true for a brief period when people in the gold market are figuring out the effects of the new policy, but it is not credible for any longer period. To conclude that anything could happen when U.S. policy is firm, one must forego economic analysis and assume that we have nothing more rational to rely on than tea leaves.

If we consider the effects over a fraction of a year, conceivably this temporary period of confusion could last that long. But if one gives major speculators credit for ability to recognize fundamental factors, it might well be measurable in days, or even in hours. One the assumption of firm U.S. policy, the speculative demand for gold would probably fall rapidly. Presumably, under this policy, the United States would also stop participating in purchases of the London gold pool; announcement of this would probably have considerable effect in changing the odds facing a speculator. The change in speculative demand would cause substantial dishoarding of gold. That this is an important element in the total private demand is clearly indicated by the close relationship between indicators of changes in the demand for gold, such as the price on the London gold market and losses by the gold pool, and widespread fears and rumors about the stability in the value of the dollar and the British pound. The private absorption of gold has also varied, according to such estimates as exist, with such speculative fears and rumors. These fluctuations cannot seriously be attributed to fluctuations in industrial use, let alone in hoarding by peasants, literate, or illiterate.

All this assumes, as I have noted, that the policy is firmly embarked on by the United States. Of course, if speculators think the United States will change its mind, and might even switch to a policy of buy-

ing and selling gold at a price above \$35 an ounce, it is true that anything could happen. The policy should not even be referred to as an alternative in the course of negotiations unless there is a serious intention of carrying it out.

Consistency with Bretton Woods Agreement

Before stating my own questions about the merits of this proposal, it is worth considering whether it is consistent with the articles of agreement of the International Monetary Fund, since some commentators have said they think it is not and any serious inconsistency might add a crucial obstacle to adopting it if support on the merits were not widespread.

It has been argued that the articles of agreement impose upon the United States the obligation to buy as well as sell gold at \$35 an ounce. It is true that article IV, section 2 prohibits a member of the Fund from buying gold above par value plus a margin prescribed by the Fund, and from selling it at a price below par value minus the prescribed margin, and that we have declared the par value for the U.S. dollar to be equivalent to \$35 an ounce. The Despres proposal does not envisage selling or buying gold outside these limits. So far as sales by the United States are concerned, it contemplates no change in present practice. The change in U.S. gold-buying policy that it envisages is to limit the quantity of gold bought, not the price at which we would pay for it; whatever gold the United States did buy, it would continue to buy for at \$35 an ounce. Since article IV, section 2, does not mean that gold sales or purchases are mandatory, but merely restricts the prices at which monetary authorities may buy and sell, the Despres plan does not contravene it.

Article IV, section 4(b), requires each member, within its territories, to permit exchange transactions between its currency and the currency of other members only within 1 percent of parity in the case of spot exchange transactions but it provides that this obligation is fulfilled by a member if its monetary authorities in fact "freely" buy and sell gold for the settlement of international transactions within the prescribed margins above and below parity, in accordance with section 2. The United States has notified the Fund that it is fulfilling the obligations of section 4(b) by freely buying and selling gold within the limits prescribed under section 2. Under the Despres plan, it would cease to do so, not because its gold purchases would be outside the prescribed limits but because it would cease to buy gold "freely." This means merely that the United States, instead of meeting the requirements of section 4(b) via section 2, as it now does, would have to meet them directly; i.e., by keeping foreign exchange transactions within the price limits prescribed in section 3 through foreign exchange operations, which is what other countries do. Thus, under the Despres proposal, we would have to change a unilateral commitment but would not violate article IV. The commitment to buy all gold offered to us by monetary authorities is self-imposed; neither the articles of agreement nor any other international agreement imposes any such obligation on us.

It is also argued that the articles make it possible for other countries to force gold on the United States via the Fund. This argument is based on a combination of two requirements of the articles. One re-

quirement is that the Fund must take gold from some members, either in exchange for their currencies on the initiative of the member (art. V, sec. 2) or, in the case of countries holding gold in their reserves, as payment when they repurchase their own currencies (art. V, sec. 7). The other requires the United States to accept gold from the Fund if the Fund deems it appropriate to replenish its holdings of dollars and to pay for them in gold (art. VII, sec. 2(ii)). The first element of the argument is correct, but the second requires the Fund initiative. ("The Fund may, *if it deems such action appropriate* to replenish its holdings of any member's currency * * * require the member to sell its currency to the Fund for gold.") The Fund could not force gold upon the United States because the U.S. vote plus the vote of other countries in the dollar bloc who would support the revised system would prevent such a decision.

The first link in the argument does raise a question whether the Fund would become a dump for gold ineligible for U.S. purchases. Professor Despres recognizes this problem, although I do not know if the solution of it that he has in mind is wholly satisfactory. Presumably the United States would seek to make agreements with other countries under which they would agree not to finance their purchase of foreign currencies from the Fund by payment of gold. The difficulty that might not be solved by an agreement between the United States and another member arises from section 7(b) of article V, which requires members to repurchase their currencies from the Fund under specified conditions and requires that these repurchases be paid for in specified ways, which depend partly on the composition of these reserves at the end of the year, and of the changes in them during the years. As a result, goldholders are required to pay the Fund for some portion of their repurchases with gold.

Other questions

My own chief doubts about the Despres plan arise from the fact that the proposal involves a unilateral action by the United States which would greatly increase its financial power—or rather make its financial power correspond more closely with its real economic power—and that the unilateral action might increase the existing divisions among the major Western countries, to the detriment of such cooperation as now exists. I should think it preferable first to seek improvements in the monetary system by more cooperative means, reserving the Despres plan for adoption in case we could not get what we want—or what we should want. (I shall try to indicate briefly what we should want in a letter to Congressman Reuss.) I would feel safer in trying to obtain needed reforms by agreement than in risking some of the hazards of a unilateral decision which would have to be regarded as irreversible if it were to work. I think it premature now to assume or conclude that cooperative efforts will fail. If a persistent effort along such lines fails, however, I would regard the Despres plan as the soundest and most attractive unilateral plan for solving the problem.

I have no objection to publication of my views in the record of the Joint Economic Committee's hearings.

Sincerely,

WALTER S. SALANT.

The following is excerpted from "International Payments, Debts, and Gold," by Fritz Machlup (Charles Scribner's Sons, New York), 1964:

XI. A PROPOSAL TO REDUCE THE PRICE OF GOLD

Raising the price of gold; reducing the price of gold; from dollar shortage to dollar glut; our power over the price of gold; effects upon money markets and international reserves.

Several economists have proposed that the dollar price of gold be increased. Some of them think that this would help alleviate or remedy the present imbalance in the international accounts of the United States. This implies that the price of gold would not be raised equally by other financially important countries. Others think that the price of gold should be increased everywhere and that this would supply more international liquidity, a desirable result if international trade is to continue growing in the future.

XI. A PROPOSAL TO REDUCE THE PRICE OF GOLD

I submit that these objectives would not be served well by increases in the price of gold and, indeed, that the proposals themselves have contributed to the present imbalance. Expectations that the dollar might be devalued inevitably result in mass decisions to switch from dollar balances into gold holdings, or at least in decisions not to build up further dollar balances. In raising and reinforcing these expectations, the proposals have reduced the dollar liquidity preference and increased the gold liquidity preference of the world; have therefore reduced the demand for and increased the supply of dollars in the foreign exchange markets and increased the demand for and reduced the supply of gold in the gold markets; and all this is reducing the international liquidity reserves in the process.

I cannot blame the gold buyers and gold hoarders for acting on these expectations. The historical experience of the world has been that gold hoarders usually gained in the long run, because governments and central banks have, on thousands of occasions, increased the gold price in terms of national currencies but have almost never, if ever, reduced the official gold parity. The one-way expectation—that the price of gold can go up but cannot go down—is a destabilizing factor in the international economy. Years ago I believed, as many had taught us, that this one-way expectation, by making gold a safer store of value than money, worked on the whole as a stabilizing influence, in that it held monetary authorities to greater discipline and caution. If this was true once, it no longer is. The knowledge that gold would be demanded from the monetary authorities has not, I believe, in the last 50 years kept many governments or central banks from increasing the domestic stock of money if such an expansion was considered desirable or necessary to obtain other policy objectives. If the faith in gold does not act as an effective brake upon inflationary policies, what other purpose does it serve?

REDUCING THE PRICE OF GOLD

If the proposal I am going to make should be regarded as injudicious, or even crazy, it may harm my reputation as a political economist, but I believe it cannot harm our national interests. On the contrary, I believe that the mere discussion of my proposal may prove helpful from several points of view—e.g., as a damper on gold speculation—even if it should not be accepted as the best of all possible policies. Here, then, I beg to propose that the dollar price of gold be reduced in two, three, or more installments. This would reverse historical experience, and those who persist in holding gold would lose money.

Before I offer explanations, let me make clear that the adoption of my proposal would presuppose negotiations, under the auspices of the International Monetary Fund, with foreign governments and central bankers, especially of the United Kingdom, France, Western Germany, and several others, and would require an act of the U.S. Congress, amending the Gold Reserve Act of 1934. Since I do not believe that a change in foreign exchange rates is necessary to correct the present imbalance in our international accounts, I would assume that the British and French would reduce the price of gold in terms of sterling and francs at the same time and by the same percentage. I believe that the German mark may stand some realignment and that this could be accomplished in the least painful way by Germany's reducing the price of gold a little more than the rest of us. I assume that none of these foreign governments would want us to act unilaterally, since a reduction of the dollar price of gold without simultaneous reductions in London, Paris, and Frankfurt would imply depreciations of the sterling, the franc, and the mark in terms of dollars, which they surely would want to avoid.

As to timing and extent of the proposed reduction of the price of gold, I submit that there should be ample advance notice and only moderate markdowns. For example, the first reduction might be only 2 percent, effective late in 1961 or early in 1962; the second reduction by another 2 or 3 percent, 1 year after the first.¹ I do not think we should now decide to adopt a scheme of a continually dwindling value of gold—listen, ghost of Silvio Gesell—but we should leave open the possibility that further periodic reductions may be made later. (Incidentally, while advance notice of an increase in the price of gold would be foolish and harmful, advance notice of a decline is both useful and fair.)

FROM DOLLAR SHORTAGE TO DOLLAR GLUT

Now let me offer my explanations. We have gone through a transition from dollar shortage to dollar glut while the sign of the balance of payments on current plus capital account has remained the same. That is to say, we have had a balance-of-payments deficit in this sense in the very years when everybody cried his heart out over the

¹ In order to guard against the possibility that gold hoarders would sell their holdings just before the price reduction becomes effective and then repurchase at the reduced rates, it would be preferable to schedule the reductions at shorter intervals. For example, four reductions a year, of 1 percent or three-fourths of 1 percent each, would, with the trading costs involved, prevent hoarders from switching back and forth.

dollar shortage. By means of this deficit we supplied, between 1950 and 1955, a net amount of almost \$10 billion, or over \$1½ billion a year, for reserve accumulation by the rest of the world. Despite these annual "deficits," there were many economists speaking of a chronic "surplus" in the U.S. balance of payments. This was sensible only in that the net supply of dollars in the foreign markets was less than was wanted and demanded for reserve accumulations in these years. By dollar shortage one could have meant—although few writers did—that the foreign nations wanted more than the \$1½ billion a year to build up their reserves. From 1958 to 1960 our annual deficit has been over \$3½ billion, and this represents a dollar abundance because the foreign nations do not want that much. Indeed, the net supply of dollars has been that high this year [1960] partly because there have been so many who were supplying dollars in the process of switching from dollars into gold. Moreover, the reason for the demand for dollars not being greater lies in the unwillingness of many foreign individuals, firms, banks, and central banks to see their dollar balances grow when a devaluation of the dollar appears imminent to them. Thus the present imbalance is, to a large extent, the consequence of the expectation that the dollar price of gold will be increased. Now an expectation that it will be reduced instead can do much to remedy the present imbalance.

The point, in short, is this: the balance-of-payments problems of a country whose short-term liabilities are the foreign reserves of other countries are different from the problems of most countries. For example, a given net supply of dollars on current and capital account constitutes a shortage when the demand for dollar reserves is high but an excess supply when the demand is low. The demand can be increased when holding dollars is made more desirable than holding gold, and this will be the case when a reduction in the dollar price of gold is expected.

OUR POWER OVER THE PRICE OF GOLD

Can we effectively determine the price of gold? If we reduce the price of gold from \$35 an ounce to \$34.30, will this stick—or will it be an ineffective gesture? It all depends on whether we are willing to sell any amount of gold that may be demanded at that price. If we sell without restriction and without batting an eye, the price will be fully effective—and people will stop buying gold from us. For there's no hoarder's demand for anything that he can obtain in practically unlimited quantities at a price which is sure to be lower after a while. (I am aware of the possibility that speculators will not believe our announced intentions. If we never hesitate to sell, they should learn that we really mean it.)

If the United States finds it proper, for some reason, to continue the present practice of selling gold only to central banks and treasuries, then we should arrange for some of these monetary authorities to keep the gold market always so well supplied that the price cannot rise, even for a few minutes, above our gold export point. In my opinion, the \$40 episode should have been avoided, and even to allow a \$36 price in London was bad management on our part.

Incidentally, the 25 percent gold certificate reserve requirement for our Federal Reserve banks should be abolished in any case, so that the

whole world will know that our gold is for sale—all of it, if anybody wants it. Of course, under these circumstances nobody will want it. On the contrary, almost everybody will want to sell his gold. In a sense, it is too bad that we should again give good dollars, and possibly good resources, for gold which will be virtually useless to us; but noblesse oblige. We may reduce, but probably should not destroy, the value of gold, and hence we should be willing to peg the price of gold by buying what is offered at the prices we fix. And other responsible financial centers of the West should do likewise.

As soon as it is decided that the price of gold in dollars, pounds sterling, francs, marks, etc., will be reduced, the offerings of gold will increase rapidly. The South Africans will want to sell all they can before the price reduction becomes effective. The same is true for Soviet Russia, which one can safely infer has been holding back for quite some time in the expectation of an increase in the gold price. (The proposals to increase it have got the hopes of the Russians and the South Africans up; they will be sorely disappointed, but I cannot get myself to weep tears over their disappointment.) Several central banks also will want to avoid a loss in their reserves and will, if a reduction of the gold price is announced, prefer to switch from gold into key currencies. Finally, there will be those who have switched from dollars into gold and will now switch back into dollars and other key currencies. It has been quite expensive for them to pay for storage and insurance and to forgo interest on their gold holdings, but they do not mind as long as the gold price is expected to rise. But if it is to fall instead, every day of holding on to the gold would be foolish squandering. We do not know how many billion dollars' worth of gold will appear from everywhere for sale to the monetary authorities, but it will be plenty if the proposal is adopted.

EFFECTS UPON MONEY MARKETS AND INTERNATIONAL RESERVES

The effect upon interest rates can be quite significant. The rash of new sterling balances, dollar balances, mark balances, resulting from gold sales to the monetary authorities is apt to mean such a rapid increase in the supply of liquid funds that—if I may assume neutral effects upon business expectations—short-term rates may be reduced to levels not seen in the last 2 years, and long-term rates, too, may come down from their lofty heights and send ailing Government securities up to par. I suspect that these side effects of the reversal of the gold-price expectations would not be considered undesirably by most of us.

One last question: How would international liquidity reserves be affected in the long run? Triffin wants an international supercentral bank to provide more liquidity. My proposal is not incompatible with the Triffin plan; indeed, it meets one of his objectives; namely, to remove the destabilizing effects of recurring flights out of key-currency reserves into gold. The advocates of gold-price increases hold, quite correctly, that an increase in the gold price would add to the reserves, first, because given stocks of gold would represent more money and, second, because new gold production would be more profitable and would therefore provide larger flows of gold. What I propose avoids the windfall profits to Soviet Russia and South Africa but would provide larger liquidity reserves by getting gold out of the hoards. It would release gold from speculative reserves to transactions re-

serves. Expressed differently, an increase in the price of gold would increase the total supply of gold, though it might also increase the speculative demand for gold; a gradual decrease in the price of gold would reduce the demand for gold. As the demand for gold for speculative purposes is reduced, international liquidity reserves are created both by increasing the amounts of gold available for transactions reserves and by making dollar balances and other key-currency balances more acceptable as international reserves.

I do not advance my rather unorthodox proposal as a solution to all problems concerning the imbalance in the international accounts. While I regard my proposal as more than a "gadget" or "gimmick," I do not regard it as a substitute for sound monetary and financial policies in this or any other country.

THE DIEBOLD GROUP, INC.,
MANAGEMENT CONSULTANTS,
New York, N.Y., July 28, 1965

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR: It is a pleasure and an honor to respond to your letter of June 22, asking for my view on the suggestions which have been put forward with respect to the U.S. balance-of-payment position in general and the U.S. gold buying and selling policies in particular.

Although I support modifications of the international monetary system to achieve increased international liquidity, this statement of views is confined primarily to actions which the United States could take in the immediate future. Nothing in the suggestions which follow is intended to preclude such a restructuring of the international exchange system as may be appropriate. It is my belief that the purpose of modifying the international monetary system would be furthered by U.S. policies designed to free itself not only from the dead remnants of the old gold standard but from self-imposed and fundamentally self-defeating restrictions on the movement of commercial transactions.

I am convinced that whatever measures are taken by the United States can only be effective in the long run—and probably in the short run—if they are nonrestrictive. Historically, those nations which have applied restrictions to their international economic transactions have done so either in the misguided hope for economic benefit or for deliberate political purposes which they were willing to purchase at an economic sacrifice. In either event, restrictive measures on international economic transactions—outside the case of war but, sometimes, even in the case of war—have led to major evasions and then to further, more stringent restrictions in repetitious succession until the system broke down. Examples are numerous. Billions of dollars of Latin American private capital, during the late 1950's and early 1960's, seeped under and through the Latin American exchange control systems. Multipartite barter trade and arbitrage networks evade Egyptian and other import licensing and exchange control systems and result in little or no decrease in total foreign exchange outflow and in substantial, inflationary price increases for

the domestic consumers. And now we have the first serious U.S. attempts in recent peacetime history to impose controls.

As is well known, imposition of the interest equalization tax did not curb the outflow of funds. It only redirected this flow into loan money which is now also restricted through the amendment sponsored by Senator Gore. Although I do not know if any attempts were made to evade the reduction of the duty-free tourist import allowance from \$500 to \$100, further partially successful action was taken by the Government to increase this useless nuisance. Certainly, if any hopes were held that the reduction of the import allowance would discourage U.S. travel abroad, disillusionment by now must have set in. I shall deal with the "voluntary" investment controls further on in this statement.

The nonrestrictive measures which I advocate are the following:

1. The United States should terminate its guarantee to buy gold from foreigners at \$35 per ounce or at any other predetermined price.

2. The United States should sell gold on the world market until it has forced the price of gold to the lowest point permitted by the prescribed margin set under article IV, section 2, of the International Monetary Fund agreement.

3. The United States should propose at the September meeting of the International Monetary Fund that all restrictions be removed regarding the price at which national governments may sell gold to each other or to third parties.

4. The United States should eliminate the gold reserve requirement against Federal Reserve notes in circulation.

5. The United States should abrogate by 1966 its program of "voluntary" investment curbs overseas, permit the interest equalization tax to expire in 1967, and remove those restrictions on the purchase of foreign products by defense contractors which first were imposed for balance-of-payments reasons.

It seems to me that these actions, more than volumes of words on the part of the President and Government officials, would provide convincing proof of the soundness of the dollar, our willingness to stand by that soundness, and our confidence as the greatest exporting and creditor nation of the world. I should now like to discuss these suggestions in somewhat greater detail.

THE DEMONETIZATION OF GOLD

The proposal to abrogate the U.S. guarantee to purchase gold at \$35 an ounce or any other predetermined price was first discussed by Dr. Howard S. Piquet in a study prepared for the House Foreign Affairs Committee in 1961. Subsequently, the idea was suggested in the minority report of the Joint Economic Committee in 1962. Since that time the proposal has been supported by Mr. Donald C. Cook and by Dr. Fritz Machlup. Dr. Machlup had previously suggested a somewhat similar plan whereby both the buying and the selling price of gold would be reduced gradually over a period of time. However, since then he also has given his support to the simpler proposal of abrogating the U.S. Treasury guarantee to purchase gold at any price.

The principal objections to this proposal which I have heard over the past 5 years—and I might note to a decreasing extent, as people have come to understand its utmost simplicity and logic—are the following:

1. *It would "upset the applecart."*—The first reaction of U.S. bankers was that people would not understand the real meaning of such a move, that they would think the United States is devaluing the dollar instead of devaluing gold, and that hysteria would intensify. The answer to that objection is simple. In the first place, the large speculators in gold against the dollar and the large banks which could cause a run against the dollar are not quite so stupid as to invest large sums of money in a proposition they have not studied carefully. However, even if they were so stupid, the crisis quickly would subside, as dollars with which to purchase gold became scarcer, and the net result would be a number of people with gold holdings purchased at a ridiculously high price. They could never hope to recover their money.

2. *The result would be for European banks to purchase gold.*—This argument was put forward principally by European central bankers and economists, whose banks already held large gold balances and relatively small foreign exchange reserves. I have the feeling that they knew exactly what was going to happen—namely, that they would not be able to get rid of their gold—and that they did their best to frighten us out of such a move.

3. *The threat that the United States would not purchase gold at a guaranteed price is senseless because nobody would want to sell us gold.*—The principal answer to this argument is that we do not need gold and do not care whether someone offers it to us or not. However, once the price of gold starts going down, those banks and individuals holding sterile, non-interest-bearing gold—the only virtue of which has been that it can go up but not down in price because of the U.S. guarantee—would be strange and superstitious indeed, if they did not wish to sell their gold to the United States or anyone at the best price still available.

4. *Such action would be in violation of the International Monetary Fund Agreement.*—The answer is simply that the agreement prohibits the purchase and sale of gold above or below a certain price. Nothing in the agreement prohibits a member from not purchasing gold.

It appears incongruous to me that the U.S. dollar which carries the burden of our foreign assistance and military expenditures, as well as the responsibility for turning the wheels of world trade, investment, tourism, and other transactions, should also have to support the price of a metal called gold.

Why must we support the worth of gold, by guaranteeing to all foreigners who hold this metal that, whenever they need dollars to repay their debts to us or buy goods and services from us, we shall accept their gold and pay them for this gold at the rate of \$35 per ounce?

1. By this guarantee of the gold price, we place a floor beneath the speculators against the dollar. We encourage the hoarding of gold by individuals and by foreign central banks.

2. By this guarantee we bring into operation against the dollar Gresham's law. For, whatever we may say with respect to standing behind the value of the dollar in terms of gold, and even

though we have \$13 billion worth of gold to back up our pledge, world opinion, backed by tradition and superstition, continues to doubt our ability. However, they have no doubt that, if we desire, we can always pay \$35 for an ounce of gold. Therefore, gold in the eyes of the world is better than the dollar. According to Gresham's law, it disappears, leaving the supposedly less valuable dollar in circulation. But, if it should not be clear that the United States will always redeem gold at a fixed price, the psychological advantage of gold would vanish.

At this point, it may be of interest to present some concrete examples of how gold speculation and hoarding can and does proceed, as well as some of its consequences.

Gold constitutes the only commodity or type of investment the buyers of which enjoy a U.S. de facto guarantee against losses exceeding a fraction of a percent of the current price, while profit chances are many times as high. With the rising concern about the dollar, this unique situation has impressed itself upon the reasoning and actions of speculators, investors, gold producers and bankers all over the world and resulted in certain types of activities illustrated by the following examples:

1. A speculator orders a Swiss bank to buy for his account on the London gold market 1,000 ounces of gold at, let us say, the free price of \$35.20 (January 8, 1965) and to finance that purchase by a loan of \$35,200. The Swiss bank borrows dollars on the New York money market at 4 to 5 percent and exchanges them into pound sterling which the Bank of England has to supply by absorbing \$35,200 at the official rate of exchange of \$2.80 for £1. The Swiss bank then converts the pound sterling into 1,000 ounces of gold, which the Bank of England has to sell in order to prevent a sharp rise of the free gold price. To obtain the gold the Bank of England has to ask the U.S. Treasury to redeem the \$35,000 originally sold to it by the Swiss bank, thus causing a reduction in the U.S. gold stock by 1,000 ounces. Subsequently, the speculator holds with the Swiss bank 1,000 ounces of gold and owes it \$35,200. Thanks to the U.S. guarantee of a minimum price of \$35 for an ounce of gold, the speculator's risk is limited to \$200 which may be increased to \$700 by fees and interest for 3 months. There is little doubt that international banks will be willing to grant such a U.S. Government insured loan of \$35,200 to any speculator who, in addition to 1,000 ounces of gold, deposits Sw F3,000 Swiss (about \$700) as collateral. All the speculator stands to lose are \$700, if the free gold price should drop to the parity level within 3 months, while he may gain some \$17,000 should the dollar be officially devaluated by one-third; he may even expect much higher profits, if governmental restrictions were imposed upon the London gold market and gray markets would take its place. While methods applied are manifold and may differ from those described above, all such transactions result in the reduction of the U.S. gold stock or in the increase of U.S. short-term liabilities, and a margin of about \$700 suffices to cause the outflow of \$35,000 worth of gold.

2. A very direct way in which both the balance-of-payments position and the gold stock of the United States are affected

adversely by speculators in gold against the dollar is the following: A speculator holding, let us say on January 8, 1965, \$35,200 within the United States transfers this sum to a Swiss bank, buying Swiss francs. Thus, \$35,200 are debited to the U.S. balance of payments. He orders the bank to purchase 1,000 ounces of gold, which is done under the procedure outline above, and which returns the U.S. balance of payments to its previous state, minus \$200. Then, however, he orders the bank to borrow for him \$35,000, using his 1,000 ounces of gold as collateral. The U.S. balance of payments is debited for this amount. The speculator, paying relatively low interest for a loan against such collateral, invests the \$35,000 in higher yield securities or equity. Since the United States guarantees him at least \$35,000 for his gold, he runs the risk of losing only \$200, which within weeks should be covered by the earning from his investment. Also, he actually loses in profits the amount of money he pays as interest on the loan. However, he does have \$35,000 profitably invested and, at the same time holds 1,000 ounces of gold which, he hopes, will rise in value either on the free market or as the result of devaluation. Thus the United States not only has a \$35,200 deficit in its balance of payments, but in addition, loses 1,000 ounces of gold.

3. Investors in nearly all free countries outside the United States are permitted to buy and own gold. Yields on hard currency bonds are about 3-6 percent. There is a general consensus that a devaluation of the dollar would be followed immediately by that of most other currencies in order to avoid enormous losses of the official holders of dollar balances and drastic reductions of exports to the United States and to soft currency countries. Conservative European investors, therefore, can decide to forgo for the time being the interest on their bonds, switch into gold and await the outcome of the so-called dollar crisis. Even if the purchase of gold by such private investors is not accompanied by a sale of dollars, its effects are the same: The investor purchases gold on the free London market and deposits it in his private vault. The Bank of England which has to intervene on the gold market can only satisfy the excessive demand for gold by converting its short-term dollar balances into bullion. If it were not for the U.S. minimum price guarantee of \$35 for an ounce of gold, cautious investors would think twice before investing their savings in a metal which is just another commodity; for that matter platinum is not being hoarded, even though it is more precious than gold.

4. Gold producers are inclined to withhold their production from the market and to hold out for higher prices as long as a minimum price of only a fraction of a percent below the current market price is guaranteed by the U.S. Government. This applies to private producers of South Africa as well as to the U.S.S.R.

THE DUMPING OF GOLD

I suggest that the United States not only should abrogate its guarantee to purchase gold at a predetermined price but should sell gold on the world market until it forces down the price to the limit per-

mitted by the International Monetary Fund. Article IV, section 2 of the agreement reads:

Gold purchases based on par values.—The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin.

Although the pressure of time has prevented me from confirming the exact margin allowed, I believe it to be 1 percent. This would mean that the U.S. Government could sell gold until the price reached \$34.65 per ounce. But, whatever the margin may be would not really matter because it would mean a gold market which would require a considerable increase in the narrow margin on which the gold speculators operate. Furthermore, of course, even though the United States might not be able to sell gold at a lower price, this would not prevent other speculators and private banks and institutions from doing so and forcing the price of gold into an accelerating decline.

It has been estimated that the sudden dumping of between \$2 and \$3 billion worth of gold on the world market by the United States would be enough to start the price of gold on a continuing decline. It is quite clear that there are not enough freely convertible funds available to private individuals or institutions for the mopping up of such a sudden flood of gold. It is equally clear that such an action would have to be undertaken with at least the tacit approval of most of the central banks of nations with freely convertible currencies. These central banks would have to agree that they would not contribute their funds to any mopping up operation designed to save the speculators. I think, however, that the plan could survive the defection of one or two of the major countries—France, for instance.

THE INTERNATIONAL MONETARY FUND

The actions I propose should be and probably must be undertaken with the cognizance and at least tacit approval of the major members of the International Monetary Fund. The operations of the United States and the objectives of the free world, as developed over the past 20 years do not allow for maverick moves in the economic sphere. Even though it is true that the United States could go it alone, needing neither gold nor the economic support of others, the whole purpose of maintaining the viability of the international balance-of-payments system through U.S. economic strength is to uphold and foster the prosperity of the free world. In the long run, of course, such a course is the only one which will assure our own continued security and progress.

Therefore, I suggest not only that approval be sought for the abrogation of our guarantee to purchase gold and for our purpose to dump gold, but that the United States broach the idea of eliminating the effective floor price on the sale of gold. This move alone could lead the speculators to the kind of fundamental self-questioning which would have an extremely healthy effect on the price of gold. The very fact that the United States is seriously proposing a policy leading to the removal of the guaranteed price for gold should shake the confidence of those whose only doubts adhere to the dollar.

COMPLETE ELIMINATION OF GOLD RESERVE REQUIREMENTS

In order to lend credibility to the moves suggested above, it is necessary to free the entire U.S. gold reserve for the purpose of international transactions. This is not to say that the reserve actually will be needed. Probably, if we wish, the reserve will be increased. With a limit beyond which we cannot commit our gold always close at hand and before the eyes of the world, our position is being whittled away. The support we wish to give to our contention that the dollar is the real determinant of value and that gold is only supported by the dollar demands that we rid ourselves of the hopelessly archaic notion that in some way gold stands behind the dollar domestically.

As former Secretary of the Treasury Dillon has pointed out, the gold reserve requirement against Federal Reserve notes demonstrably has not influenced domestic economic policies over the past three decades. As he also pointed out last February, maintenance of this requirement would suffice to cover an orderly expansion of currency for only 10 years—and less than 10 years if there were a further outflow of gold.

Is it really necessary to involve gold, which has become almost exclusively an instrument of foreign economic policy, in an attempt to set limits on domestic currency expansion? By doing this we weaken our international strength, while accomplishing nothing domestically that could not be done as well or better by other means. I suggest, if Congress indeed does wish to give some indication to the independent Federal Reserve as to the limits of currency expansion over the next 10 years, that it may do so by legislation. For instance, the Congress could stipulate that Federal Reserve notes in circulation may not exceed \$55 billion before December 31, 1975. Such legislation can be adjusted by succeeding legislation at any time, as can the gold reserve requirements. However, it would not carry with it the psychological implications which now support the action of the speculators.

THE REMOVAL OF RESTRICTIONS

I am aware of the success which the "voluntary" program of foreign investment restrictions has had over the past 6 months. Principally, it provided an important lesson to our European friends. It taught them that we are tough. Nonetheless, I support Dr. Fritz Machlup's statement to the subcommittee of the Senate Committee on Banking and Currency on March 17, 1965, in many of its particulars regarding the deleterious consequences of the threat of international exchange restrictions. As Dr. Machlup points out, when this threat which already had given rise to serious maladjustments in the financial transactions of U.S. business during the last part of 1964, actually is implemented—as it was by the "voluntary" investment restrictions—the worst fears of the business community are confirmed. I suggest that, if the U.S. Government over the past few years had given convincing evidence of its faith in our fundamental international economic strength, the threat would not have existed and would not have had to be implemented. Instead, the Revenue Act of 1962 sought to penalize certain types of international investment, the interest equalization tax and the subsequent Gore amendment imposed further barriers, imports by Defense contractors were cut, tourists were inconvenienced—all for balance-of-payments reasons.

Thus, the "voluntary" restrictions may have been made necessary by the very possibility that they would be imposed. Although they have been successful up to now, they are defensive and contribute nothing positive to our international economic objectives of freer trade and investment. They cause the buildup of the kind of natural economic pressures which can be contained only by further restrictions through law and sanction. Before the "voluntary" program collapses under the pressures of corporate obligations to stockholders and workers, it should be ended. Before the object lesson it has provided is erased by statute and regulation, U.S. confidence in the dollar should be affirmed by allowing the dollar to operate freely. In other words let's quit while we're still ahead.

Our fundamental balance-of-payments position is sound. The dollar is sound. There is no need for a basic adjustment in our international position through domestic or long-term foreign action. The principal causes for the apparent balance-of-payments difficulties of the United States reside in expectations: the expectations, now justified, on the part of U.S. business that their free access to foreign markets would be impaired, and the expectations of the speculators in gold against the dollar that for one reason or another, either because of dogmatic and oversimplified restrictions or because of a general erosion in our world position, the value of the dollar would decline. Such expectations, especially when partially confirmed, can result in an acceleration of events contrary to natural economic forces and preventable by reasonable men.

In this connection, I should like to quote an aside by Dr. Machlup in his statement of last March: "Some analysts of 'feedback effects' ask themselves what the foreigners do with the money they receive and cannot do if they do not receive it, but fail also to ask what the Americans do with the money which they are prevented from transferring." I would say that at least some of this money is invested by the Americans domestically. This can be good in the long run, when needed to expand capacity and modernize industry in order to prevent demand inflation. However, in the short run it can be harmful if it puts further pressure on an economy which already is showing incipient signs of wage and demand inflation. Also, in the long run it can be harmful, if it diverts American business from taking advantage of optimum investment opportunities, from assuring themselves of a place in foreign markets, and from returning over the years increasing amounts of earnings for the benefit of our international balance of payments and our domestic economic prosperity.

In conclusion, since I have already touched on the incipient inflationary pressures on the domestic economic scene, it seems to me that the time soon will come when the discount rate can be raised for domestic reasons—as it should be—with the favorable ancillary result of strengthening the short-term capital category in our balance of payments. Such a rise in the discount rate, preceded or accompanied by the removal of restrictions on U.S. purchases and investment outflow, could represent a first step toward the nonrestrictive international economic policy suggested in this statement of my views.

I deeply appreciate this opportunity of presenting my views to the Joint Economic Committee.

Sincerely,

HERBERT J. BLITZ, *Director of Research.*

NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.,
New York, N.Y., June 30, 1965.

Hon. JACOB K. JAVITS,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR: Thank you for your letter of June 22 inviting me to prepare a statement regarding proposals for modification of our gold-buying policy. I shall need to review the more recent statements on the subject to see if there is anything which I might usefully add. I should be able to reply more definitely in advance of the hearings. In the meantime I should like to recall that, to the best of my knowledge, the very first suggestions along this line were made in an amusing but perspicacious article entitled "Where the Rainbow Ended" in the *Economist* [of London] in its issue of December 24, 1960, a copy of which is enclosed. I do believe that this piece merits a place in the history of the subject.

With kind regards,
 Sincerely yours,

HAL B. LARY.

[Reprinted from the *Economist*, Dec. 24, 1960]

THE BUSINESS WORLD
 WHERE THE RAINBOW ENDED

By a deft stroke, the *Economist* has got hold of the memoirs of Dr. Per Jacobsson 10 years before they are written. Chapter 4, "The Brainwave of 1961," has a certain topical interest.

It was, in the words of that firm exponent of stable money, the Duke of Wellington, a damned close run thing. Speculation against the dollar, momentarily quieted by President Kennedy's inauguration, flared up suddenly again in March. The main cause seems to have been the bid made by General Motors for British Motor Corp., to which the United Kingdom Government gave its approval on condition that the bid be deemed to cover British Railways as well. This was fine for Britain, but it pushed the U.S. gold reserves below \$16 billion, and the fact that no more than two-fifths of the world's gold was buried under the United States naturally shook everyone's confidence in the stability of dollar prices.

Soon the pressure proved too much for the loose understanding that had been reached about management of the London gold market. The dollar price of gold shot up and on April 1 was quoted at \$49. This time it could not so easily be brought back under control. Investors the world over, disillusioned with dividend cuts on their growth stocks, reverted to more ancient habits, and bought gold.

Plainly something had to be done. The economists, rising to the occasion, called a world conference in Fiji to thrash the matter out. After meeting all through the Easter vacation they issued a considered statement of 10,000 words which pointed out that fundamentally there was no problem. In a closely argued minority report, Sir Ralph Hawtrey identified the trouble to the undervaluation of sterling in 1949.

Still the exchange and bullion markets seethed. Samuel Montagu opened a recruiting office in Coventry. In June the Directors of the International Monetary Fund unanimously agreed that there should be no annual meeting that autumn. The markets heaved a sigh of relief. Soon after, however, an eavesdropper to a meeting of the National Temperance Council at Haywards Heath, England, reported a mystifying discussion about par values and fundamental disequilibrium. Worst suspicions were confirmed when it was found that 15 Professor Skinners had registered at the Station Hotel.

So it appeared, that bleak and rainy summer, as though the world's currencies would after all have to succumb. The world's best economic brains, its most eminent practical bankers, had thought hard and long; but none had found a means of breaking the speculators' grip. More and more of them, privately, were beginning to think that the only way of getting rid of the speculators was to give in to them. The dons, back with their Fiji tans, were turning over the problem that had eluded them to their students. "Explain in 500 words what you consider to be the best means of checking the present flight from the dollar into gold." It livened up the seminars. But by one of those strange strokes of coincidence that go to the making of history, the paper of one of the students, a certain Joe Plain, did very much more.

It all happened because Mr. Plain discussed his paper one evening with his father, a principal in overseas finance at the Treasury. For 2 days Mr. Plain senior did nothing. Then, in the most tentative way, he passed up a memorandum to his assistant secretary. In the ordinary course of events, I have no doubt, matters would have stopped there. But this assistant secretary happened to be an old pupil of Prof. J. K. Galbraith, now chairman of the Federal Reserve Board; and he felt it permissible, on an academic rather than an official level, to pass on to his old teacher the academic musings of his junior's no doubt unwordly but ingeniously minded son. On Friday, July 7, he airmailed a copy of the paper to the professor's home address.

Who will ever forget the Monday that followed? It came as a thunderbolt not only to the public at large but to the whole financial community, from Treasury officials to central bankers. It came in the form of a short statement by the Federal Reserve Bank of New York, acting as agent for the U.S. Treasury:

In recent months doubts have been thrown on the continuance of the policy of the Federal Reserve in buying and selling gold at the parity of \$35 an ounce, on the ground that market forces are inexorably pressing toward a higher price. The Federal Reserve has no wish to hold back the forces of the market. Forthwith, therefore, its undertaking to buy and sell gold at \$35 an ounce, or at any other price, lapses.

In three sentences, the Fed had demonetized gold. The financial markets were knocked dizzy. The event was too large for men to take in. As they began working it out, they fastened on another statement which on my own initiative I put out for the International Monetary Fund:

The Federal Reserve Bank of New York announced today that it is ending its undertaking to sell gold to central banks at \$35.08¾ and buy gold from any source at \$34.91¼. The Fund approves this step. As an interim arrangement, until December 31, 1961, the Fund is taking over the commitments of the Federal Reserve, with certain differences. It will buy gold, at \$35 less commission, only

from central banks of its member countries, who will receive in return deposits with the Fund which can be used for all international payments; and it will be happy to sell gold at \$35 plus commission to anyone. It assumes no obligation to buy gold after December 31.

So, as the city editors quickly explained, anybody who held gold had better sell it quickly. For 6 months gold still had a value near \$35, provided one's national central bank agreed to act as intermediary between the public and the International Monetary Fund. From the new year on, gold would be just a commodity, and busy calls went round to try to establish just what, as a commodity, gold would be worth.

Not everyone was happy with the discovery. The Zurich nursing homes had to open emergency wards: "It is the shock, the shock" the harassed doctors were heard to mutter. Kuwait decided to postpone its new retirement pension plan for all Arabs anywhere. Other countries saw their problems solved. In India the peasants were already carrying their gold into the banks; within 3 days the Finance Minister announced that the Indian Government now had sufficient reserves at the IMF to dispense with all external aid for the third-year plan. The Bank of France, too, enjoyed a windfall from its own people, and General de Gaulle's first impulse to make a proper hydrogen bomb gave way to a grand plan for full integration with Algeria at the French scale of social services, accepted by the Muslims by popular acclaim.

There were, of course, certain problems. South Africa was thunderstruck by the ruthless devaluation of its most important export commodity; it would not object to selling all its gold to the Fund but could not possibly dig it all out of the Rand in 6 months. The Fund offered special arrangements, the only condition being that South Africa should abolish apartheid; and after a bloodless coup d'état South Africa gratefully accepted. The other hard-hit gold producer, Russia, chewed over the problem a little longer. Here the Fund was asking simply that Russia should become a member and, in accordance with article VIII, end all restrictions on current payments. The old guard fought passionately against; but Mr. Khrushchev—"Are we going to let the capitalists rob us of the value of our tens of billions of hard-dug gold?"—prevailed, and announced the decision on the same day as the cession of 1,000 square miles of Mongolian desert to China. Most dramatically of all, even Switzerland decided to break with all precedent and join the Fund, though two cantons preferred to set up their own central banks; since the gold in their balance sheets has no ascertainable value it is to this day recorded in ounces.

This revolution in international finance of course transformed at one stroke the status of the International Monetary Fund. "The Fund," one commentator wrote, "now stands to the central banks of its member countries as does the Federal Reserve Board to its member banks." Possibly this was somewhat premature. At any rate the Fund secured a new hold on the public mind. In the vernacular, there was a rush to jump on the bandwagon. In response to strong pressure, I myself agreed to serve a second term as Chairman and Managing Director. And recently we have been fortunate enough to persuade Lord Cromer to give up his promising start as Governor of the Bank of England to return to his old and now highly coveted post as Executive Director of the Fund.

We have of course outgrown our new building, and at an early stage it was thought appropriate to move west, to a splendid new glass structure built over Fort Knox. In the early days visiting finance ministers were comforted by the sight of the bars of gold on which, as they still saw it, the security of their IMF deposits rested. But such outmoded thinking soon lost sway, and when at a recent annual meeting the Governor for the United Kingdom, under pressure at home to economize in his budget, pointed out that no less than \$2.50 an ounce for gold could be obtained from dentists, the meeting decided there and then to put the whole lot out for public tender; a running income was assured by leasing Fort Knox to a grateful U.S. Defense Department for underground nuclear tests. The base of world liquidity at last broke free from its golden chain, and was determined instead by the hydraulic calculations provided free of charge by Professor Kendall of the London School of Economics.

So the operation that may well have saved the economy of the Western World was brought to its triumphant conclusion. For the student of affairs, it brings two striking lessons. The first concerns the means by which the change was brought about. I well remember how the governor of a European central bank, who must be nameless, told me a few years ago that much the same scheme had been suggested by one of the less experienced delegates at that Haywards Heath gathering. "And what happened? It was laughed out of court." The central banks would refuse to cooperate; they would hang on to gold, which history had endowed with value, rather than part with it in exchange for a typewritten entry into the books of IMF. So much for the view of the men of the world, for whom money was a fixed and unchanging thing.

Yet just in those years Professor Sayers and the Radcliffe committee in England had reminded the public that money was whatever the public chose to accept as such. The same is true internationally. That is my second lesson. To those who doubt this, to those who feel that positive control over the course of economic events must for some reason stop short at the terms of international exchange, I need only say remember the year we demonetized gold.

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
New Haven, Conn., July 21, 1965.

Senator JACOB K. JAVITS,
*Joint Economic Committee,
U.S. Senate, Washington, D.C.*

DEAR SENATOR JAVITS: Your kind letter of June 25 has just caught up with me here at the Rockefeller Foundation in Bellagio.

I am asking my secretary at Yale (Mrs. Hovey) to send you a copy of my latest study of the international monetary problem, and a full list of my publications. She will be delighted to forward you any other study in which you might have an interest.

I have not seen all the papers mentioned in your letter, but am familiar with Professor Machlup's and Despres' proposals. While in full sympathy with their broad view regarding a gradual withdrawal of our floor under the gold price, I regard it as totally academic in the

short run, and impossible to negotiate at the present juncture. Most of all, I deplore Professor Despres' suggestions:

(1) That we "go it alone" and attempt to impose unilaterally our own solution on others, without further ado about international negotiation and cooperation with our partners regarding what is after all a world problem.

(2) That we aim at forcing them to replace gold by the U.S. dollar as a world reserve medium.

Both suggestions seem to me both impractical and contrary to our own interests as well as to the interests of a viable world monetary order. They can only feed anti-American arguments abroad about our alleged "irresponsibility" in this field and the need to dissociate the international reserve system from its present excessive dependence on the dollar.

I would be delighted to take up again these problems with you after my return to the States next September, if you wish. May I try and contact you in Washington during the IMF meeting?

With fond memories of your forward-looking questions and comments in your hearings, and best personal wishes.

Yours sincerely,

R. TRIFFIN.

EMB (LTD.),
RESEARCH ECONOMISTS,
Washington, D.C., June 25, 1965.

DEAR JACK: This is in reply to your letter of June 22 requesting my opinion of the proposal that the United States should announce that it will no longer buy gold at \$35 an ounce, but will continue to sell gold at this price. Those who advocate this measure must be unaware of the consequences of such a change in our gold policy.

In considering the merits of such a proposal, we should note that we have an international obligation to buy as well as sell gold at \$35 an ounce. The Articles of Agreement of the International Monetary Fund contain a number of provisions which impose such an obligation on us.

Article IV, section 1, states: "The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the U.S. dollar of the weight and fineness in effect on July 1, 1944 [i.e., \$35 a fine ounce]." Under this provision we have declared the parity of the dollar to be equivalent to \$35 an ounce.

Article IV, section 2, states: "The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin." The Fund has prescribed the margin as 1 percent from \$35 an ounce. It can be argued that this does not make gold purchases mandatory, but merely provides that when such purchases are made they must be at \$35 an ounce adjusted for a margin of not more than 1 percent.

Article IV, section 3, states: "The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territory shall not differ from parity, (i) in the case of spot exchange transactions, by more than 1 percent."

Article IV, section 4(b), requires each member, within its territories, to permit exchange transactions between its currency and the curren-

cies of other members only within this limit. In order to enable the United States to fulfill this obligation without supervising exchange transactions, the same section further provides: "A member whose monetary authorities, for the settlement of international transactions, in fact freely buy and sell gold within the limits prescribed by the Fund under section 2 of this article shall be deemed to be fulfilling this undertaking." The United States has notified the Fund that it does and will buy and sell gold freely at \$35 an ounce under this provision.

Article VII, section 2(ii), states:

The Fund may, if it deems such action appropriate to replenish its holdings of any member's currency * * * require the member to sell its currency to the Fund for gold.

As the Fund must take gold from its other members for dollars (art. V, sec. 2, and art. V, sec. 7), any country in the world can sell gold to the United States at \$35 an ounce through the intermediation of the Fund.

Article VIII, section 4, requires members to convert balances of their own currencies held by foreign central banks and "the buying member shall have the option to pay either in the currency of the member making the request or in gold." This means that if we accumulate French francs, we can have them converted into dollars or gold (at \$35 an ounce) at the option of France. Of course, we are under no compulsion to accumulate francs. In that case, France will be able to force gold on the United States by buying dollars from the Fund, and when the Fund is short of dollars it can compel the United States to buy gold.

In mentioning these international obligations, I do not intend to say that the question of U.S. gold-buying policy should not be examined on its merits. I merely say that the present international monetary system in all its ramifications is based on the continuation of the present U.S. policy of both buying and selling gold at \$35 an ounce. If it can be shown that this obligation is detrimental to the interests of the United States or those of the world economy, there would be a case for proposing the necessary changes in the Fund agreement.

The advocates of the proposal to have the United States stop buying gold at \$35 an ounce believe that this will reduce speculation in gold against the dollar. The general idea is that gold speculators now have an open-end speculation for a rise in price of gold, but no risk of a fall in the price of gold. This argument has little merit, except for very short-term speculators. Since the establishment of the gold pool, the price in London has been as high as \$35.20 an ounce. The theoretical low in the London market can be \$34.65 an ounce. Thus, the range in the dollar price of gold in the London market can be as much as 55 cents an ounce. But the cost of a speculative position in gold is not measured by the potential fall in price. It also includes the cost of engaging in the transaction (buying and selling commissions), storing the gold in a vault, and the cost of tying up money in gold. As interest rates are very high outside the United States, even a borrower with a good credit rating must pay more than 6 percent. This means an annual cost of over \$2.10 an ounce to carry the gold position, apart from commissions, other carrying costs, and risk of price change. As a practical matter, speculators as a group have lost heavily on gold

over the past few years. The alternative before them, to hedge against a change in the dollar price of gold by buying U.S. common stocks, would have brought them large gains instead of large losses. Even an investment in U.S. bonds would have been much more profitable for speculators.

Actually, speculation has very little to do with the drain on U.S. gold reserves. Since 1958, when the deficit in the U.S. balance of payments became large and persistent, the average increment of gold in the monetary stock of all countries outside the Communist bloc, but including the international monetary institutions, has been about \$610 million a year. In this same period, production of newly mined gold has averaged about \$1,230 million a year. The U.S. Bureau of the Mint estimates the amount of gold going into industry and the arts at about \$300 million a year over the past 7 years, with about one-third used in the United States. Allowing for net gold sales of about \$200 million a year by the Soviet Union, the apparent increase in private hoards has been about \$500 million a year.

Properly speaking, even this increase in private hoards cannot be treated as speculative. It is customary for people in the Middle East and Far East, to say nothing of the peasants of Western Europe, to put part of their savings into gold, just as Americans buy savings bonds, make deposits in savings accounts, or acquire shares in mutual funds. These hoarders of gold are not looking for a speculative profit, but for a traditional investment. They absorb by far the greater part of the gold output and gold sales of the Soviet Union that do not go into monetary and industrial uses. The absorption of gold in the revolving stock that moves among speculators—that is to say, the calculating buyers and sellers of gold waiting for a change in the dollar price—is relatively small.

In truth, the proposal is intended to be a warning to the monetary authorities of the gold-holding countries who have acquired billions of dollars of gold in the past 7 years rather than to the private speculators who have absorbed a few hundred million dollars of gold in the same period. From 1958 to 1964 inclusive, the six large surplus countries of Western Europe increased their gold holdings by \$9 billion. In this same period, the net increment of gold reserves of all countries outside the Communist bloc, but not including the international financial institutions, was nearly \$3.6 billion and the decrease in the gold reserves of the United States was nearly \$7.4 billion. In the past 7 years, the six large surplus countries of Western Europe absorbed all of the net increment of monetary gold as well as a large part of the gold sold by the United States. In fact, U.S. net gold sales to the six large surplus countries of Western Europe were about \$4.2 billion in the period from 1958 to 1964.

It cannot be assumed that the decision of these countries to acquire gold instead of holding dollars was based on any speculative notion that the dollar price of gold would be changed. These countries are well aware of the underlying strength of the U.S. competitive position and of the capacity of the United States to restore its balance of payments once it decides to take the necessary measures. Their holdings of gold instead of dollars is part of their traditional pattern of behavior. They have always been gold-holding countries. Beyond

that, they regard the conversion of dollars into gold as part of the discipline required for avoiding a persistent balance of payments deficit financed by their accumulation of dollars. Their balance of payments surplus is expanding their money supply at a time when they are experiencing price and cost inflation. This undoubtedly was a factor in their decision to put pressure on the United States to end its deficit. Finally, the surplus of these six countries with the United States came from a heavy volume of private investment which involved to some extent an unwelcome foreign ownership of important segments of their industry.

The drain on our gold reserves does not arise from mischievous conduct by the surplus countries. It arises from our large and persistent payments deficit. The United States must bring its payments into balance. Even if we could, through economic or political pressure, induce other countries to continue to accumulate larger reserves in the form of dollars, it would not be in our interest to have them do so. The world has been very tolerant of the deficit in the U.S. balance of payments. It would never have financed such a deficit for any other country. While there have been political overtones in some recent conversions of dollars into gold, even our best friends are troubled by the long delay in taking effective action to eliminate our payments deficit. In the past few weeks I have talked to the governors of most of the central banks of Western Europe. They are gratified that we are now acting forcefully to restrain capital outflow and they are confident that our present program will be successful in restoring a balanced payments position.

Suppose the United States were to announce that it would no longer buy gold at \$35 an ounce, although it would continue to sell gold at this price. What would be accomplished by the announcement? It would not deal with the real problem, which is the payments deficit, not the gold outflow. It would not cause other countries to reduce or halt their gold purchases for fear of being unable to resell the gold later to the United States, which is the real purpose of the proposal. That is because these countries know that in practice the United States will buy gold at \$35 an ounce when our balance of payments is in surplus, despite any announcement to the contrary we may make now.

Consider what the proposal states and implies regarding the exchange policy of the United States. The advocates of this policy say: "We believe that the United States must avoid devaluation by continuing to sell gold to foreigners at \$35 an ounce." But they accept without hesitation the converse of this proposition, that we will accept an appreciation of the foreign exchange value of the dollar by refusing to buy gold from foreigners at \$35 an ounce when we would otherwise have a balance of payments surplus. As a practical matter, this means that we could not run a balance of payments surplus at all, except as countries draw down their dollar reserves for this purpose (which would not be very large for Western Europe) or as we accumulate francs, marks, and other currencies in our own reserves. Of itself, such a policy would ultimately mean devaluation of the dollar. We would not accumulate gold reserves when we would normally have a surplus and we would pay out gold reserves when we have a

deficit. This would result in recurrent deficits without offsetting surpluses.

Nor can we face with equanimity the appreciation of the foreign exchange value of the dollar in a period when our balance of payments is stronger. In 1964, the United States exported \$5.4 billion of crude materials and crude foodstuffs, and \$1.7 billion of manufactured foodstuffs and beverages. Suppose when our balance of payments is stronger, the dollar appreciates because we refuse to buy gold? Then, in order to sell the \$2.5 billion of our grains and grain preparations we export, we would have to lower our price to offset the appreciation of the dollar. To sell the \$700 million of cotton we export, we would have to lower its dollar price. To sell the \$500 million of tobacco we export, we would have to lower its dollar price. To sell the \$400 million of animal and vegetable oils and fats we export, we would have to lower their dollar prices. Alternatively, we could give larger subsidies for such exports or accumulate larger Government surpluses. Who would advocate lower farm prices or larger Government subsidies if the alternative is to buy gold at \$35 an ounce?

The problem is not essentially different with our exports of manufactured goods. In 1964 we exported \$14 billion of finished manufactures and \$4 billion of semimanufactures. This embodies the work of about 1.5 million factory employees. Suppose when our balance of payments is stronger, the dollar appreciates because we refuse to buy gold. Then, our exports of manufactures and semimanufactures will fall, their prices will tend to decline, and profits from exports will be eliminated. If this should occur when our labor force is growing and when the number of our unemployed is still large, it would aggravate the most serious economic problem confronting the United States. Who would advocate letting the foreign exchange value of the dollar appreciate, with its adverse effect on employment, if the alternative is to buy gold at \$35 an ounce?

Those who advocate announcing that we will sell gold at \$35 an ounce but not buy gold at this price in the future are able men, but they are trying to be psychologists instead of economists. Do they think that the world can be forced to accept a dollar standard instead of the present gold exchange standard by our unilateral action? The dollar is the principal reserve currency and the most important currency in international payments. But the world will not be forced or cajoled into making it the sole monetary standard by threat to refuse to buy gold. The world can be induced to continue to hold dollar reserves, to build up working balances and liquid investments in dollars, to keep the dollar the currency for international lending and investing, but only if we show that our economy is strong and our international payments will be in balance.

We have a very difficult problem. That is to find the combination of policies that will enable us to restore our balance of payments and at the same time accelerate our economic growth under conditions of price stability in order to reduce unemployment and wipe out the pockets of poverty. To a very large extent, the measures necessary to achieve the domestic and the international objectives of our policy are consistent. That is to say, when we hold down our prices and costs, we strengthen our net exports, we increase employment, and

we maintain the purchasing power of the dollar. In one important field, capital movements, the interest and credit measures necessary by themselves to restrain capital outflow sufficiently would have an inhibiting effect on the domestic economy, although not necessarily as much as is generally assumed. We can and must find means to hold down capital outflow until the present extraordinary surge of U.S. investment abroad subsidies and interest rates come down in foreign financial centers. And we must do that without restricting domestic investment, production, and employment. Our new program for voluntary restraint of capital outflow is designed for that purpose. We must retain it until the present excessive foreign investment (\$6.4 billion in 1964) is reduced by normal economic forces or until our surplus on goods and services is sufficient to finance such a capital outflow. At the same time, our fiscal, debt-management and credit policies should be designed to strengthen the effectiveness of the voluntary program.

There is one attitude we must avoid—that is, a feeling of frustration. Over the past few years, a large part of the enormous improvement in our surplus on goods and services has been offset by the increase in private capital outflow, so that our balance of payments, although much better than it was a few years ago, still shows a large deficit. We must start from where we are and this time we must make sure our new efforts are completely successful. It does no good to act like Liza Doolittle and say to the surplus countries of Western Europe, “Just you wait, ‘Enry ‘Iggins, just you wait,” threatening them with dire consequences in the future by refusing to buy their gold. The fact is that when the time came Liza Doolittle did take Professor Higgins with great eagerness, and we shall do the same with the gold that is offered to us at \$35 an ounce, less the Treasury’s handling charge of one-eighth of 1 percent.

The present international monetary system is based on reserves of gold, dollars and other foreign exchange, supplemented by reserve credit from the International Monetary Fund, and reciprocal credit arrangements among the large industrial countries. That system has worked reasonably well, although it has become excessively dependent on the accumulation of reserves supplied by the U.S. payments deficit. We must retain the present system, but strengthen it through the creation of a new type of reserve asset which can be increased at a regular rate, without depending on a U.S. payment deficit, and which can be used jointly with gold in international settlements in order to reduce the excessive sensitivity of the world economy to gold movements. Such an evolution of the international monetary system cannot come about by a decision of the United States to refuse to buy gold while we continue to sell gold. Any changes in the international monetary system must be made in cooperation with the large industrial countries and it must provide for participation by all other countries through the International Monetary Fund.

I shall be glad to have you insert this in the record of the hearings that the Joint Economic Committee will hold on the reform of the international monetary system.

Sincerely,

EDWARD M. BERNSTEIN.

MEMORANDUM OF CONVERSATION WITH PROFESSOR FRIEDRICH A. LUTZ
OF THE UNIVERSITY OF ZURICH ON NOVEMBER 13, 1963

Present: Prof. Friedrich A. Lutz, members of the Joint Economic Committee staff, and other staff personnel from congressional and executive offices.

Rapporteur: Gerald A. Pollack, Joint Economic Committee.

Professor Lutz was asked to comment on the suggestion that the United States discourage foreign buying of its gold by continuing to sell gold at \$35 an ounce while terminating its guarantee to buy gold at \$35 an ounce or at any other predetermined price, or by actually setting a lower gold-buying price.

Professor Lutz stated that changes in U.S. gold policy along the lines suggested would cause consternation abroad and seriously disrupt the network of international monetary cooperation which has evolved in recent years. Foreign central banks, whose primary concern is the preservation of the value of their international assets in terms of their national currencies, would be reluctant to add to their gold holdings if gold could be sold back to the United States only at a loss. They would probably not wish to sell their existing gold reserves because this would cause them to incur losses. Dollars would appear preferable to gold, at least at first.

Thus it might appear that the United States had achieved the optimum position for a debtor: the deprivation of its creditors of any good alternatives to continuing existing credit and extending further credit.

But the situation might not develop so clearly to America's advantage. Professor Lutz suggested that the only certainty about the proposed policy is that in the beginning foreign central banks would prefer dollars to gold. But it is open to question how long they would be willing to continue holding dollars. If they were placed in the position of financing the U.S. deficit continuously by accumulating dollars, they would obviously say "no" at some point.

Moreover, private holders of dollars abroad, with more than \$6 billion in dollar balances, might no longer be willing to hold large balances in the face of the new uncertainties and would perhaps begin to sell their dollar holdings in the foreign exchange market. If they did, the central banks would be faced with the difficult choice of supporting the exchange rate by acquiring the dollars offered or allowing the dollar to depreciate. It seems unlikely that they would amass anything like \$6 billion to support the exchange rate, and it therefore seems probable that the dollar would decline in international value.

Foreign countries which hold more dollars than they desire can always cut down on their dollar balances by spending them within a fixed exchange rate framework. In private enterprise economies where decisions are decentralized, this would imply that governments should create incentives for private parties to spend more abroad. The most direct way this could be done would be through domestic inflation to increase the attractiveness of foreign products relative to domestic goods.

Another alternative would be for foreign countries to place restrictions on sales of goods, services, and assets to the United States so as to reduce the inflow of dollars into these countries.

The United States, of course, might not wish the dollar to decline in value, even though such a decline would help to restore balance to U.S. international payments. But if the U.S. gold policy were changed along the suggested lines, the U.S. gold stock would no longer constitute a monetary asset. The United States would thus lack substantial international assets with which to support the dollar exchange rate. Under these circumstances, if the dollar were to be supported, it would have to be at the discretion of other governments. Other countries would have an incentive to maintain the exchange rate of the dollar, because a decline in that rate would increase the competitive advantage of the United States at home and abroad. On the other hand, it could not reasonably be supposed that they would support the dollar indefinitely at the expense of adding continuously to their dollar holdings when they no longer had the option of switching between dollars and gold virtually without cost. Already we have reached the point where they ask themselves "should we hold dollars" because they are not sure that they will always be able to change dollars into gold.

When a draft of this memorandum was sent to Professor Lutz so that he could check whether ideas were correctly attributed to him, he amplified and developed further his views on the implications for the international monetary system if the United States were to sell gold at \$35 an ounce and buy it at a lower price. Professor Lutz wrote:

* * * I have now come to the conclusion that in case the buying price for gold were lowered in the United States the European countries would immediately withdraw from the dollar; i.e., they would maintain the exchange rate between themselves, use gold as a medium of payment between themselves (at the old price)—

and cease to acquire additional dollars. They might possibly even sell their existing dollar balances for U.S. gold.

Using a U.S. gold selling price of \$35 an ounce and buying price of \$17.50 as a hypothetical example, Professor Lutz wrote:

If America chose \$35 an ounce of gold as the selling price and \$17.50 as the buying price and stuck to it while the Europeans withdrew from the dollar in the way indicated in my letter, the Americans, under present circumstances, would have to support the dollar at the present exchange rate by selling gold. If the Europeans only ceased to accumulate additional dollars; i.e., took the surplus entirely in gold but did not sell existing balances, the support of the dollar by selling gold could go on for a while, provided the U.S. balance of payments became progressively less passive and eventually active. If the Europeans sold existing dollar balances as well, the Americans could not stick to the price of \$35 an ounce, the policy would have to be given up and the dollar would depreciate.

Suppose now the U.S. balance did get active. Then the U.S. dollar would appreciate. The Europeans could, if they wanted to, support their currencies vis-a-vis the dollar once their rates had fallen to half what they had been (e.g., 8 deutsche marks equal \$1) by selling gold to the United States at \$17.50 the ounce. But this is their free choice—they could let the dollar rise still further. The Americans could prevent a rise of the dollar only if the monetary authorities were willing to accumulate foreign currencies.

But the main point is the the double gold price scheme would not induce the European countries to choose dollars rather than gold, but to abandon the dollar entirely. The scheme is all right for all these who want flexible rates for the dollar. But in this case it is also unnecessary. The only purpose it would serve would be to permit the monetary authorities to carry the gold stock at a price of \$35 in their books.

The discussants considered what might happen to the world price of gold if the United States were to abandon its present gold buying and selling policy in favor of the suggested plan. Professor Lutz expressed the view that the price of gold would fall because the commitment of a central bank to buy gold at the fixed price of \$35 an ounce forms the backbone of the gold market. However, the discussants suggested that, if prohibitions against private ownership of gold were eliminated, the price of gold might not fall much, or might even remain at \$35 an ounce. It could even conceivably rise.

Professor Lutz noted that the proposal that the United States change its gold-buying price while maintaining the gold-selling price differs from another plan which is frequently mentioned—that countries broaden their buying and selling margins above and below the par value of gold. This proposal is intended to increase the permissible range of exchange rate variation from the present limits of 1 percent on either side of par for spot transactions. But Professor Lutz noted that, so long as foreign central banks are willing to buy and sell dollars at set prices, it doesn't matter what the gold price is so far as the exchange rate is concerned.

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
New Haven, Conn., June 29, 1965.

Senator JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR JAVITS: I greatly appreciate your inquiry about the gold plans. Gerry Pollack has meanwhile called to the effect that I would be asked to testify. In that case, I probably ought to embody my reaction to the gold plans in my testimony and shall do my best to convey the point adequately.

May I summarize what I think:

1. As long as we have a deficit, the threat not to buy gold without limit at its present price is an empty one. I am by no means convinced that our deficit is over.

2. Even when the deficit is ended, a unilateral demonitization of gold would be a very rough kind of action and would bode ill for future international monetary cooperation.

3. In either case, changing the buying price of gold would be unsettling. It might be taken as a signal that we were getting ready to stop selling gold. It is not at all certain that the rest of the world would follow our demonitization. Many speculators might feel that after some interregnum of disorder and fluctuation, gold would emerge as the world's monetary standard at a higher price.

With best regards.

Sincerely yours,

HENRY WALLICH.

The following article is excerpted from Newsweek, issue of September 6, 1965:

TINKERING WITH GOLD

(By Henry C. Wallich)

Uncertainty about the world currency outlook has once more focused attention upon gold. Some want to increase its price, some want to reduce it, some want to make it uncertain what the price is going to be and some want to stop buying gold altogether. At the risk of seeming unimaginative, I confess that I can discover only one common denominator: the proposals all would cause trouble.

The most persuasive advocate of the price-raising school has been General de Gaulle's silver-tongued gold expert Jacques Rueff. His proposal to double the gold price would give all gold-holding countries a 100-percent profit, and remove any threat of deficient world liquidity. The principal defects: it would throw back the evolution of the world monetary system by decades, would give the biggest profits and liquidity gains to the wrong countries, and put the United States in the position of having cheated countries that hold dollars instead of demanding gold. The merest hint that such a scheme was under serious consideration would produce a violent onslaught on our gold reserves by dollar-holding countries.

PAY LESS?

The school that wants to cut the price of gold has a much more subtle proposal. We would continue selling gold as now at the price of \$35 per ounce. But we would announce that we will pay a steadily diminishing price for it, if we ever again had occasion to buy it, say \$34 the first year, \$33 the next, and so on. Foreign countries would then have to anticipate that their gold reserve would depreciate in terms of dollars. They would stop demanding more gold from us, perhaps sell us what they have.

Could we pull this one off? The chances are that we could not, and we should not if we could. So long as we have a payments deficit and are selling gold, it is a hollow threat to say that we will lower the buying price. The conclusion most likely to be arrived at by foreign countries is that we had reached a state of despair about our affairs and would shortly begin to finagle the selling price as well. Confidence in the dollar would fall, not rise. But if we should reach a payments surplus and be in a position to buy gold, we would, by reducing the gold price, appreciate the dollar against all countries that kept the value of their currency stable in terms of gold. American goods would be priced out of world markets.

LET IT FLUCTUATE?

The proposal for making the price of gold uncertain would have the U.S. Treasury raise the charge it levies upon the purchase and sale of gold. The conservative version of the proposal would raise it to, say, 1 percent, from its present level of one-quarter of 1 percent. Countries then might not switch between gold and dollars so readily to avoid the 2 percent round-trip commission. Meanwhile, the dollar price of gold would fluctuate between the Treasury's buying and sell-

ing points, leaving its value mildly uncertain. But since countries, in order to own gold, must already forgo an interest of about 4 percent per year available on dollars, the extra 2 percent probably would not affect them much.

A bolder version says: let us raise the charge to, say, 7½ percent both ways. We would then have a flexible exchange rate, within this range, with respect to countries that maintain their currencies stable in terms of gold. The chances are that this would work out simply as a concealed devaluation of the dollar.

The proposal to stop buying any gold, finally, or to buy only a limited amount, is a naked power play to impose the dollar as the sole world currency. It would be little more ethical to refuse to sell countries dollars for the gold we had previously sold them, than to refuse them gold for the dollars they are now holding. And suppose we tried to rise above ethics, we might just find that we had deprived our customers of the means of paying us, should we ever develop a payments surplus. Meanwhile, the rest of the world might decide to ignore our threat and play the gold game without us.

The proper approach to gold is gradually to reduce its role in the world monetary system. That process has been going on for many decades. Sudden action to disestablish it would leave us with a vacuum.

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
New Haven, Conn., July 9, 1965.

Hon. JACOB K. JAVITS,
*U.S. Senate,
Washington, D.C.*

DEAR SENATOR JAVITS: In response to your request of June 22 I submit the following comment, and I have no objection to its publication.

I think a distinction should be made between buying gold from private sellers in free gold markets and buying gold from other central banks.

At present the United States participates with other countries in a "pool" which buys and sells gold in the London gold market to confine the free market price within narrow limits. But the effective floor price at which the pool buys virtually guarantees speculators against loss. I think the United States should seek the agreement of the pool never to buy gold in the free market, so that there is no floor whatever on the price. Other governments should be informed that the governments participating in the pool will never buy gold from them if they purchase in free markets. Governments, including the U.S.S.R. and the Union of South Africa, should acquire all gold newly mined in their countries. If they wish to sell it for monetary use, they should sell it directly to the U.S. Treasury or other governments rather than in the private market. I believe that this would be an effective device for discouraging private speculative hoarding of gold. If the other members of the pool do not agree, I think the United States should seriously consider executing the plan unilaterally.

Withdrawing the U.S. guarantee to buy monetary gold from other central banks is a more serious step, and it is difficult to appraise it apart from all the other aspects of U.S. international monetary

strategy. By itself it is a device to increase foreign official demand for dollars as reserves. While I look forward to a system in which gold plays a smaller role, and ultimately no role at all, I believe it must be replaced by a truly multilateral international money rather than by any single national currency, even dollars. If we really try to obtain an international agreement along these lines, including provisions for consolidating present U.S. short-term official liabilities, and if we fail, then I agree that we must consider unilateral changes in our gold policy.

Sincerely yours,

JAMES TOBIN,
Sterling Professor of Economics.

BARNARD COLLEGE, COLUMBIA UNIVERSITY,
DEPARTMENT OF ECONOMICS,
New York, July 12, 1965.

Hon. JACOB K. JAVITS,
*Ranking Minority Member,
Joint Economic Committee,
Senate Office Building,
Washington, D.C.*

DEAR SENATOR: This letter is in response to your request (June 22, 1965) for my views on a proposal that the United States terminate its guarantee to buy gold from foreigners at \$35 an ounce, but continue to sell gold to foreign governments and monetary agencies at the fixed price of \$35 an ounce.

In my judgment, it would be a serious mistake for the U.S. Government to take any such action. Should the policy prove successful, it could achieve its success only by being destructive. But it is unlikely that it would do what its advocates apparently think it would do; namely, so reduce demand for gold as to cause its price to decline sharply and thus impose losses on those who presently hold it. Actually, there is a strong private demand for gold today, as witness the results of recent gold sales in which private purchasers have taken all newly mined gold and then some. Furthermore, I see no lessening in the willingness of governments and central banks to substitute gold for their holdings of foreign exchange. At present, gold is a more important component of international liquidity than all foreign currency holdings combined. And, as you know, the French have for several months been taking all settlements in gold. I expect you will find a good many other countries doing the same.

As for using the plan to embarrass the French, this would be essentially negative diplomacy in a situation in which the United States should be providing constructive leadership. Because I don't think the plan would actually depress the price of gold, I doubt that it would hurt the French or anyone else (except the United States, by making it look foolish, petty, mischievous, vindictive and disposed to act in a way unbecoming a great world power); but if it should succeed in depressing the value of gold, it would undermine the value of liquidity balances throughout the world, to absolutely no good effect and possibly to great harm.

In addition, the proposal diverts attention from what is the basic problem in international economic relations today; namely, the breakdown of the "key currency, gold exchange standard" system. That breakdown is due, of course, to the unwillingness of major industrial countries of the world to absorb more U.S. dollars and more British pounds as part of their international liquidity reserves. And this unwillingness traces to the fact that both we and the United Kingdom—the two key currency countries—have been a good deal less than successful in avoiding large and prolonged deficits in our international payments.

The problem is all the more perplexing because it has a kind of paradox at its source, as follows: the key currency system, using the U.S. dollar as its major currency-type reserve, cannot work if deficits in the U.S. balance-of-payments flood the world with dollars; but neither can it work if the U.S. international payments shifts suddenly to a large surplus, restricting international liquidity in the process. Under our present "key currency" system there has to be some deficit in U.S. international payments in order to supply increases in international liquidity, but these deficits cannot be so large or so prolonged as to flood the world with dollars and, thereby, undermine the value of dollars already in the balances of foreigners, public and private. What we must do is strike a better balance between a large deficit and a large surplus. And because of our failure to do this, the international monetary system—as it is constructed today—has broken down.

As you know from the testimony I gave last winter before the Joint Economic Committee (Feb. 25, 1965), I attribute our failures to "strike a better balance" to the administration's unwillingness to shape its national economic policies, notably its monetary policy, to the needs of our international economic situation. I will not pause to argue the point here, but I do not agree with the so-called consensus that, in the present context, a policy that is right internationally need be wrong domestically. To me, this is one of the most objectionable parts of the current mythology.

Naturally, I am unhappy that the world has been let down by the United States in this way, and I am unhappy that the U.S. dollar has suffered the rejections that it has; but the fact is that our dollar-based international monetary system has been seriously impaired and a new one must be devised. There isn't a ghost of a chance that whatever system we end up with will permit the United States to run large deficits in its international payments, whether or not we count deficits as including increases in the private foreign holdings of short-term dollars. Thus, the basic requirement remains: we must achieve a better balance in our international payments.

There are two important points to be made on this matter:

First, we must not swing suddenly, and heavily, from deficit to surplus. This would be seriously constrictive of international liquidity in the rest of the world. And its effect would be uneven among countries; some would be affected to the point of being forced into a foreign exchange crisis. Indeed, for us now to start withdrawing U.S. dollars from the rest of the world in large amounts after having flooded it with dollars these past seven and a half years, would be unforgiveable mismanagement. The world is in no shape today to have the United States pull the rug out from under it in a massive withdrawal of U.S. dollars.

The second point is that we should be using the full weight of U.S. influence to assure that whatever system is ultimately agreed upon as a substitute for what we now have will be—

(1) So constructed that it will promote world trade and finance, and give every encouragement and assistance to the elimination of barriers to international transactions; i.e., it should be in the tradition of "free trade," if you will, for which the United States has been the leading proponent since the days of Cordell Hull's epochal efforts;

(2) So designed as not only to supply the international liquidity that is needed in increasing amounts as world trade and finance expands, but will provide also for orderly adjustments in international payments positions (with appropriately sized and administered stabilization credits, as needed) when individual countries run excessive deficits, or surpluses.

There is little point for one outside of government and not privy to the discussions now going on concerning alternative plans for remodeling the international monetary system to go into details on how it should be done. Suffice to say that it should solve both the liquidity problem and the adjustment problem; and that it should get us off the road to essentially nationalistic, regionalistic and antiliberal trade policies and practices on which we have of late been traveling, and back onto the internationalist road which is our best tradition. In this context, the proposal that we should announce to the world that we are no longer willing to buy gold is totally out of place.

As ever, with warm personal regards,

RAYMOND J. SAULNIER.

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK,
DEPARTMENT OF ECONOMICS,
New York, N.Y., July 14, 1965.

HON. JACOB K. JAVITS,
U.S. Senate,
Committee on Labor and Public Welfare,
Washington, D.C.

DEAR SENATOR JAVITS: Thank you for your letter of June 22 inviting me to comment for the record on the recent proposals regarding U.S. gold-buying policy. I append a brief statement. I should be quite pleased to have it made part of the committee's transcript.

Sincerely,

PETER B. KENEN,
Professor of Economics.

Most of the proposals for a change in gold policy have two basic provisions in common. First, they agree that the United States should continue to sell gold at \$35 an ounce to foreign official institutions. By implication, then, they do not contemplate any change in the structure of exchange rates connecting the dollar with other major currencies and are not aimed at improving the U.S. balance of payments. Second, they propose a reduction in the price at which the United States will buy gold or a limitation on the amount of gold we will buy when others seek to sell it. They thereby hope to force dis-

hoarding of gold by private foreign holders and governments alike. If foreign holders are persuaded that they will soon receive fewer dollars for their gold, or that they will not be able to sell us gold at all, the incentive to hold gold might be greatly reduced, and foreigners might disgorge large quantities of gold (or reduce accumulation out of newly earned reserves). Thus, these proposals are narrowly aimed at alleviating the pressure on the U.S. gold stock.

I am in full sympathy with this objective. I would, indeed, go much further and "demonetize" gold. At this juncture, however, I doubt that we could greatly alter foreign gold preferences, private or official. Indeed, any change in our gold-buying policies might have perverse effects in the very short run. Until the world is quite sure that we have eliminated our payments deficits, such a change is apt to engender new doubts about the dollar and speculative purchases of gold, however irrational, rather than speculative sales. I likewise doubt that a change in our policies would substantially alter the practices of those foreign central banks that have been buying the most gold during recent months. The French decision to buy U.S. gold with all newly earned reserves is consistent with a longstanding preference for gold, but is also a deliberate tactic adopted to goad the United States into a more rapid attack on its payments deficit. Any new American effort to buy more time, as by reducing pressure on the U.S. gold stock, will only serve to reinforce the French conviction that we have been too slow and cause the French to redouble their efforts, whether by larger gold purchases or other means.

There is one other point to be made in this connection. Let us suppose that the United States declined to buy gold from any foreign central bank. Under the Bretton Woods agreement, we would then be compelled to stabilize the dollar by outright intervention in the foreign-exchange markets (see art. IV, secs. 3 and 4). If, then, France were someday to suffer a deficit in its balance of payments, we would be compelled to buy French francs with dollars (to prevent an appreciation of the dollar vis-a-vis the franc). France would have access to dollars, even though she held all her reserves in gold. This possibility blunts the threat conveyed by the proposals to reduce our buying price for gold or limit gold purchases.

Finally, I fear that any unilateral change in our policies may wreck newborn hopes for an orderly reform of the international monetary system. Even as current French policy is sadly reminiscent of the policies France followed in 1928-29, so any change in American policy will evoke an ominous echo of 1933-34, when this country undermined the London Conference, designed to reestablish harmony in international monetary affairs.

PETER B. KENEN,
Professor of Economics, Columbia University.

