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NEXT STEPS IN INTERNATIONAL MONETARY REFORM

REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

SEPTEMBER, 1968

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NOTE

This report contains the separate views, beginning on page 8, of Senator Jacob K. Javits, ranking minority member of the subcommittee.

LETTERS OF TRANSMITTAL

SEPTEMBER 18, 1968.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is the report of the Subcommittee on International Exchange and Payments entitled: "Next Steps in International Monetary Reform." The report has been approved unanimously by the members of the subcommittee.

The subcommittee wishes to express its gratitude and appreciation for the guidance it has received from the experts who appeared before it as witnesses.

Sincerely,

HENRY S. REUSS,
Chairman, Subcommittee on
International Exchange and Payments.

SEPTEMBER 19, 1968.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a report of the Subcommittee on International Exchange and Payments entitled: "Next Steps in International Monetary Reform."

The views expressed in this subcommittee report do not necessarily represent the views of other members of the committee who have not participated in hearings of the subcommittee on the drafting of its report.

Sincerely,

WILLIAM PROXMIRE,
Chairman, Joint Economic Committee.

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NEXT STEPS IN INTERNATIONAL MONETARY REFORM

I

OBJECTIVES OF A SOUND INTERNATIONAL MONETARY SYSTEM

An evolutionary process is slowly but surely transforming the international monetary system.

Occasionally changes have been made in response to specific challenges that, although recognized as incipient dangers, could not be foreseen clearly. Thus, when purchases by speculators earlier this year threatened to drain the Gold Pool nations of their gold reserves, central bankers from these seven countries met in Washington and in a March 17 communique resolved to halt both sales and purchases of gold in private markets. During the succeeding months the private market price of gold has not risen to the extent that speculators and financial pundits anticipated. Moreover, existing gold reserves have been preserved, and the dollar has been spared from a potentially grave assault on its international reserve status.

In contrast, other modifications of the system have resulted from long and arduous negotiations. Last spring representatives of the 10 major industrial nations met in Stockholm to reach final agreement on the details of an amendment to the Articles of Agreement of the International Monetary Fund that provides for Special Drawing Rights. When this amendment is ratified, its acceptance will represent the culmination of an exhaustive series of discussions beginning in 1965. Although adoption of an amendment requires approval by countries holding 80 percent of the total voting power in the Fund, to date only 12 countries, holding 39 percent of the total votes, have approved the SDR facility. Furthermore, after ratification of this amendment, the consent of members holding 85 percent of the total voting power will be required to activate the facility and actually distribute SDR's among Fund members. Consequently, the process of creating new reserve assets has been deliberate indeed.

But the international monetary system will still be in need of further modification even after the distribution of SDR's. Despite this step toward assuring an adequate supply of international liquidity, there is little evidence to indicate that U.S. payments deficits will be substantially curtailed in the immediate future. Moreover, the dollar will continue to be vulnerable to official demands for conversion into gold. Because of this vulnerability, some foreign officials will still feel constrained to hold more dollars than they might otherwise prefer. But unlimited conversions of dollars into gold could endanger both the value of foreign dollar reserves and the multilateral payments system. The foreign exchange value of the pound is similarly vulnerable to demands for conversion into dollars. Thus, we continue to face the related problems of uncertain confidence in the two major reserve currencies and of failure to effect the adjustments needed to halt long-standing payments deficits.

In considering steps toward the solution of these problems, it is important to keep in mind the type of international monetary system that, once established through the evolutionary process, would be equally acceptable to all nations. The objectives of international

monetary reform are (1) an adequate supply of *liquidity*, (2) a symmetrical *adjustment* mechanism that promptly eliminates payments deficits, and (3) full central bank *confidence* in the future value of reserve assets.

First, the supply of international *liquidity* should be independent of such fortuitous events as the discovery or exhaustion of gold seams in South Africa, weather conditions in the wheat-growing regions of the Soviet Union, the benevolence or malevolence of gold-mining countries, the propensities of Americans to export or acquire factories abroad, and changes in the expectations of speculators. Instead, the supply of international liquidity should be determined by the members of the IMF, according to their desire for reserve gains and their willingness to tolerate reserve losses. As Professor Machlup has pointed out, "The 'need' for international reserves cannot be assessed except by judging the consequences of governmental reactions to gains or losses in reserves. The world 'needs' an increase in reserves if the (restrictive) consequences of governments reacting to losses of reserves are likely to be more harmful to world production and trade than the (expansionary) consequences of governments reacting to gains in reserves."

Second, the *adjustment* mechanism functioning to eliminate payments deficits should operate promptly and symmetrically. While nations should not be permitted to run payments deficits indefinitely year after year, they should be able to eliminate their deficits without substantial domestic unemployment. This requirement implies greater success in controlling internal inflation or greater reliance on exchange rate variations than has been the case to date. The adjustment mechanism should be symmetrical in that all nations experience the same type of pressure from reserve losses when running deficits.

Third, national monetary authorities should be able to have complete *confidence* in the future acceptability and value of the reserve assets they hold. This degree of confidence would preclude any need for central banks to switch from one type of asset into another, and would thus remove the threat that large-scale conversions today pose for international monetary stability.

Thus, while the *liquidity* problem may be on the way to solution, the more immediate and critical problems of *adjustment* and *confidence* remain unsolved.

II

RECOMMENDATIONS FOR ACTION BY THE IMF

The annual meeting of the IMF Board of Governors in Washington from September 30 through October 4 offers a properly timed and legally empowered forum to inaugurate essential next steps in international monetary reform. In order to speed IMF decisionmaking, the subcommittee requests the U.S. Governor to take the following action at the September meeting:

Recommendation 1

The U.S. Governor should urge all member nations that have not done so to ratify by December 31, 1968, the amendment enabling creation of Special Drawing Rights.

The 1967 annual meeting in Rio de Janeiro and the March 1968 Stockholm conference among representatives of the 10 major industrial nations offered the hope of prompt action toward international

monetary reform. But the response to date falls short of these expectations. As noted above, just 12 countries have ratified this amendment, and the United States and the United Kingdom are the only two that have contributed a significant degree of voting strength toward acceptance. Only 39 percent of the votes are in hand; 80 percent are needed. Excessive delay in ratifying the amendment would place the importance and validity of international monetary reform in doubt. Delay could be used as an excuse for continued failure to try to solve the problems of adjustment and confidence. Consequently, the subcommittee urges that the U.S. Governor take all appropriate action to encourage ratification by the end of 1968.

The subcommittee also hopes that, immediately after ratification of the SDR amendment, the Managing Director of the Fund will canvass the members in an effort to obtain approval from nations possessing the 85 percent of the total voting strength required to permit distribution. We believe that a poll of the member nations would have a constructive outcome. Nations both favoring and opposing the use of this new reserve asset would be identified, and the objections of any minority opposing immediate activation could then be discussed.

The subcommittee recognizes that some nations will have objections to the distribution of SDR's as long as U.S. deficits persist at the current level. We also note that Secretary of the Treasury Fowler has repeatedly emphasized the need for reducing U.S. net expenditures abroad. The Joint Economic Committee has vigorously supported appropriate action to bring the external accounts of this Nation into balance. In its last annual report, the committee asserted that government expenditures abroad, which are primarily military outlays ($4.25 billion annually), constitute "the root of our balance-of-payments difficulties" and that "the drain of such [military] expenditures on our reserve position must be terminated quickly."

We reaffirm this stand. The foreign exchange costs of military spending must be drastically curtailed, both to strengthen our balance of payments and to remove the block that U.S. deficits pose to international monetary cooperation and, in particular, to the activation of SDR's.

On the other hand, foreign officials would be unrealistic to insist on total elimination of U.S. deficits before agreeing to the distribution of SDR's. Activation of the SDR facility can be expected both to increase the pressure on this country for elimination of our deficit and to help facilitate an additional reduction in U.S. net external expenditures. Allocation of SDR's would belie the argument that, since gold reserves are no longer expanding, dollar deficits reflect, in part, desired increases in reserve stocks. Moreover, the availability of SDR's would decrease the likelihood that fiscal and monetary restraints applied in this country to slow inflation and to curtail our appetite for imports would be countered by similar actions abroad. Thus, a reasonable reduction in U.S. deficits should be sufficient to permit distribution of Special Drawing Rights.

We are confident that the U.S. Governor will persist in his efforts to secure ratification of the SDR amendment at the earliest possible date. The subcommittee also urges the present U.S. Governor to initiate, and subsequent Governors to expedite, three new moves—contained in Recommendations 2, 3, and 4—to continue the process of transforming the international monetary system.

Recommendation 2

The IMF Board of Governors should adopt a resolution instructing the Managing Director to appoint a special commission, in consultation with him and the Executive Directors, to submit by December 31, 1968, or as soon as possible thereafter, a proposal for establishing an IMF gold deposit or earmarking mechanism to protect monetary authorities from any decline in the value of their existing gold reserves. This facility would be activated when, in the judgment of the Managing Director, the free market price of gold had stabilized at $35 per ounce or less. Deposits would be voluntary and would entitle depositors to fully guaranteed SDR's or other reserve assets issued by the Fund. The Board of Governors would act upon this proposal immediately after its submission.

The purpose of this reform is to eliminate all ambiguity concerning the future monetary role of gold, and to protect the international monetary system from the destructive effects of either an increase or a decline in the free market price of gold.

In the March 17 Washington communique, the representatives of the seven participating Gold Pool nations agreed

"that henceforth officially held gold should be used only to effect transfers among monetary authorities, and, therefore, they decided no longer to supply gold to the London gold market or any other gold market. Moreover, as the existing stock of monetary gold is sufficient in view of the prospective establishment of the facility for special drawing rights, they no longer feel it necessary to buy gold from the market. Finally, they agreed that henceforth they will not sell gold to monetary authorities to replace gold sold in private markets."

This agreement has at least temporarily allayed fears about the future value of the dollar, and has stopped the leakage of gold reserves into the hands of private hoarders and speculators. The subcommittee applauds the monetary authorities of the nations included in the former Gold Pool for devising this ad hoc method of preserving international monetary stability. We also commend the other nations of the world that have consented, either tacitly or informally, to abide by the provisions of this agreement and hope that they continue to do so in the future. The March Washington agreement should, in the opinion of the subcommittee, effectively become a permanent part of the international monetary system.

But as the agreement stands, it has a somewhat one-sided impact, since it prevents nations from realizing the benefits of an increase in the free market price of gold without protecting them from the potential costs of a substantial price decline.

An objective of the Washington agreement was to narrow the differential between the higher private market price of gold and the official value of $35 per ounce. To the extent that this goal has been realized, however, the disturbing prospect of a decline in the market price below the official level has also arisen. If the speculators who purchased substantial amounts earlier this year were to become skeptical about the likelihood of profits and consequently began to unload their stocks, the market price could very well drop precipitously. Under these circumstances, the future reserve-asset value of official gold stocks

might also be placed in doubt. Thus, in conjunction with making the Washington agreement a permanent feature of the international monetary system, it is only reasonable to include a guarantee against the possibility of a decline in the official value of existing gold reserves.

Gold reserves deposited with the Fund (or stocks earmarked under an IMF facility) would be limited to the quantity of such reserves reported on a specific date, say March 31, 1968—the first quarterly period terminating after the Washington agreement. This provision would eliminate any opportunity to purchase gold on the market at bargain prices and then deposit (earmark) it with the Fund in exchange for more valuable reserve assets. The value of gold deposits (earmarked stocks) would be guaranteed in terms of dollars or an appropriate weighted average of several national currencies. To insure that all sales by gold producers would be channeled into the free market until the positive differential between the private and official prices has been eliminated, the deposit (earmarking) facility, although approved, would not be activated until the Managing Director was satisfied that the free market price had stabilized at or below the official value.

If the members of the special commission appointed by the Managing Director preferred an earmarking mechanism to a gold deposit facility, no physical transfer of gold reserves would be necessary. Central banks would merely notify the Fund that they wished to avail themselves of this guarantee by earmarking either the entirety or a specified portion of their gold stocks in behalf of the IMF. No change in ownership or physical location would occur. Central banks would be constrained only in that they would be pledged not to spend earmarked gold reserves. Moreover, the quantity of reserves held by each nation would remain unaltered, since reserves deposited or earmarked under this reform would be matched by equivalent accounting balances with the IMF.

In contrast to this proposal for resolving the ambiguities that may arise from a downward movement in the price of gold on the private market, the subcommittee strongly opposes any effort to reintroduce a minimum price. IMF purchases of gold at $35 an ounce would signal speculators that they once again enjoyed the benefit of monetary purchases—banned under the March 17 Washington agreement—to divert gold supplies from the free market. We therefore urge the U.S. Governor to resist staunchly any resumption of official purchases. Without official intervention at a minimum price, gold producers have no alternative but to obtain the foreign exchange needed to purchase imports and to finance investments abroad through sales of gold to private interests.

But to reintroduce a floor price would encourage a new burst of speculation. Until last March 17, the knowledge that potential losses were limited by the $35 per ounce official value of gold assured speculators that they could gain much and had comparatively little to lose. Removal of this assurance has caused some speculators to sell and has made others reluctant to buy. The reintroduction of a minimum price, however, would tend to increase speculative demand for gold, to widen the differential between the free market price and the official value, and to raise the likelihood of an initial deterioration sparking another even more serious crisis.

Recommendation 3

To remove the threat of outstanding sterling balances to international monetary stability, to insure against the possible liquidation of dollar reserves, and to place all nations on an equal footing in the financing of external deficits, the Board of Governors should adopt a resolution instructing the Managing Director to appoint a special commission, in consultation with him and the Executive Directors, to submit a proposal for earmarking or depositing foreign exchange reserves with the Fund in return for IMF reserve assets. This proposal is to be submitted for action to the Board of Governors at its September 1969 annual meeting, or as soon as possible thereafter.

As long as there are large amounts of outstanding dollar balances in official hands that can be presented for conversion into gold, and as long as existing sterling balances can similarly be converted into dollars, the monetary system will be in danger of a crisis that could precipitate its collapse. Continuation of United States and United Kingdom deficits would greatly increase the danger of such a crisis and the consequent possibility of autarchy in international trade and investment.

The special commission to be appointed under Recommendation 3 should therefore concentrate on removing the threat of these outstanding balances by establishing a reserve-currency deposit (earmarking) facility with the Fund similar to the gold deposit (earmarking) mechanism outlined in our Recommendation 2.

The alternative method—funding and subsequent amortization of these balances—is a complex one that would require extensive negotiations. As of the end of March 1968, dollar liabilities to foreign monetary institutions totaled $14.3 billion and similar sterling liabilities amounted to the equivalent of $8.6 billion. Any attempt by a reserve-currency country to amortize balances as large as these might well entail severe domestic deflationary pressures or price adjustments. To some extent, a similar burden would then be imposed on the rest of the world. Moreover, amortization would imply an equivalent reduction in the reserves of other nations. It seems doubtful that, even in the future, the supply of reserves from other sources will be sufficient to permit the liquidation of assets that at present constitute over one-third of the total stock of reserves held by all IMF members. The preferable solution, therefore, is the creation of a facility for the deposit or earmarking of dollar and sterling balances. Such a solution has been advocated by numerous distinguished witnesses before the subcommittee and reportedly is under consideration in European financial circles. The need for such a facility is only slightly less pressing than the requirement for a voluntary gold deposit facility proposed under Recommendation 2.

Recommendation 4

In view of the persistent international deficits on the part of the United States, the widespread imposition of autarchic restrictions on trade and capital flows in response to reserve losses, and an incipient rise in protectionist sentiment both in this country and the rest of the world, the Board of Governors should adopt a resolution instructing the Managing Director to appoint a special commission, in consultation with

him and the Executive Directors, to prepare a proposal permitting variations in exchange rates around the established par values greater than the present limit of 1 percent. This proposal is to be submitted to the Board of Governors at its September 1969 annual meeting or as soon as possible thereafter.

During the past decade the United States has attempted through a variety of measures to reduce its payments deficits. Foreign aid has been tied, bank lending to foreigners has been restricted, and most recently limitations have been imposed on direct investment abroad. With few exceptions—such as efforts to promote exports and foreign tourism in this country—the response has consisted of stopgap attempts to constrain market transactions that place dollars in the hands of foreigners, rather than to effect adjustments in prices and tastes that would bring an end to deficits without interference in the market process. The difficulty of eliminating net dollar outflows through such ad hoc stopgaps has been demonstrated by the persistence of deficits. Given the virtual impossibility of significant declines in domestic prices and wages, the subcommittee feels that it is essential to reexamine the desirability of wider temporary variations in exchange rates around the established par values.

We believe that any change in the basic structure of exchange rates is not only unnecessary but destined to fail if attempted. On the other hand, some modest increase in international price flexibility is appropriate, both to enable less interference with market processes and to strengthen the position of the dollar by curtailing U.S. payments deficits. A modest reform of this type would not alter the multilateral payments system established in the postwar era but would permit the system to respond with greater resilience to temporary disturbances. The need for reserves to finance short-term disequilibria would be reduced, and when faced by sharp but apparently short-lived deteriorations in their external accounts, countries would be supplied with an alternative to the imposition of import quotas or capital export controls. In fact, a modification of this type would strengthen the system of free multilateral convertibility and fixed exchange rates that has been the basis of postwar international monetary evolution.

III

Conclusion

The subcommittee's recommendations call for two sets of goals: first, activation of SDR's and provision of a Fund gold-deposit (or earmarking) mechanism by early 1969 or shortly thereafter; second, by the end of 1969 or as soon as is feasible, IMF adoption of a new reserve facility to enable the earmarking or deposit of official dollar and sterling balances and, to help curtail payments deficits, the introduction of somewhat greater variability in exchange rates.

Implementation of the subcommittee's recommendations would strengthen the international monetary system from the point of view of both the United States and the rest of the world. The dollar would be released from its reserve-currency responsibilities, while at the same time, the commitment of the United States to those holding dollars would be honored. The rest of the world would no longer fear a dollar devaluation, and the removal of present restrictions on international investment and trade would be encouraged.

SEPARATE VIEWS OF SENATOR JAVITS

I concur with the long-range goals and the fundamental objectives sought in the subcommittee report and I shall cooperate to help to attain them. As the report's recommendations are far reaching and require careful evaluation before the governments can be expected to take action on them all, I feel that the pacing and method of making the changes raise questions which necessitate these separate views.

The proposals are highly significant because they focus public attention on the goals that must be sought in the years ahead.

It has been made evident by recent events that all is not well with the international monetary system and that the world economy can no longer afford the luxury that each international monetary crisis be dealt with by ad hoc arrangements devised under the pressure of remorseless events. This is evidenced by the agreement on SDR's reached last year in Rio de Janeiro. There, the major trading nations agreed that they would take at least the first step toward a rational, consciously managed, world monetary system. It is regrettable that even this halting step has been ratified so far only by 39 percent of the 80 percent of the votes in the IMF required to implement the agreement.

As I interpret the report, it correctly emphasizes that the ultimate goal for improvement in the system should be the eventual transformation of the IMF into a central reserve bank, designed to serve the interests of the world trading community, with power—subject to the concurrence of the International Monetary Fund Board and the Managing Director—to increase or decrease reserves to meet the needs of that community rationally, rather than by the deficits in the international accounts of one or two important countries.

The burden on the dollar and the pound sterling, the principal reserve currencies at the present time, is much too heavy. Yet, no matter how much of the reserve function of the dollar is assumed by the IMF, the dollar for a long time to come will be a major currency for facilitating international trade and investment. This function is beneficial to our economy—we must not overlook that fact and therefore should not lay aside hastily this position.

The feasibility of attaining the objectives of the Report would be diminished if a specific deadline were to be set. I am pleased therefore that the Report is flexible in this respect. In view of the great difficulties involved in obtaining agreement of the principal industrialized nations even to the special drawing rights provision—a relatively minor proposal in comparison to the proposals contained in this Report—a fixed deadline, especially one set in terms of months, or even a year or two, would have opened up these proposals to superficial criticism. The proposals are far reaching and their acceptance at high official levels in the United States, as well as in Europe, will require time. Thought as to timing as well as substance needs to be given to the political, as well as to the economic consequences that flow from them.

I should like now to specify the areas where I agree with the Report, and the areas in which I believe the Report leaves questions open which bear significantly on the propriety of agreement or disagreement with its proposals.

I concur that the agreement enabling the creation of SDR's should be ratified by the end of this year. Dangers are involved in procrastination. Clearly, more than 39 percent of the 80 percent of the required votes in the IMF should have been obtained by now. I trust the forthcoming annual meeting of the IMF will be utilized for that purpose.

As one who called for the same improvement in the international monetary system on February 28 of this year (discontinuance of intervention in the London gold market) which was agreed to on March 17 by the seven nations who participated in the London gold pool, I also concur that all IMF member countries should abide by that agreement.

No monetary system can survive if, as a result of gold speculation, we come to another gold crisis and witness renewed "private" attacks on the dollar and the pound sterling. France, a key member of the Group of Ten has not specifically agreed to the March 17 Washington agreement since it withdrew sometime earlier from the London gold pool. I sincerely hope that France, acting in a statesmanlike manner—as it does even now—when it comes to essentials involving the Western community of nations, will formally endorse the March 17 agreement and will persuade other nations by her example to do likewise. The strengthening of the system must take precedence over any conflict, real or imagined, between France and the United States or other continental nations.

There are several important questions flowing from the proposals in this Report that are left open and which must be faced sooner or later. For example, recommendation 2 calls for gold deposits with the IMF to protect monetary authorities from declines in the value of their existing gold reserves. The Report states that these deposits should be voluntary but leaves open the question as to whether or not they are irrevocable. If they are revocable, a question arises as to how significant an advance such a deposit facility would represent. If they are irrevocable, there is the problem of loss of national control over such gold deposits and whether the permanent general acceptability of the new reserve units issued by the IMF in exchange for this gold would actually justify a loss in national control.

It is also not clear to me whether the pooling, or earmarking, of official dollar and sterling balances in exchange for IMF reserve assets is to be mandatory or voluntary.

With respect to recommendation 4, which would lead to wider fluctuations in exchange rates than at present (the articles of agreement of the IMF now limit variations to 1 percent), the important point to be emphasized is that unless such action is accompanied by a commitment by IMF countries to abstain from interference with international movements of capital and goods by the imposition of quantitative controls, the proposal is practically meaningless. This is so, because if the United States, for example, continued to experience persistent balance of payments difficulties and the dollar's value declines in terms of other currencies, the success of the "wider fluctua-

tion limits" scheme depends on the willingness of other nations to take our relatively cheaper exports and to allow our investments abroad without resorting to foreign exchange or import controls.

Finally, I would like to call attention to the implications of recommendation No. 4 to balance-of-payments deficits in the United States other and countries, once this recommendation is put into effect. If such an agreement is reached and truly symmetrical adjustments are allowed to take place—that is, small changes in exchange rates are permitted to take place by all countries without interference through foreign exchange or quantitative import restrictions—then each nation will be able to come close to balance-of-payments equilibrium and the practical elimination of balance-of-payments deficits. Consequently, the long-sought goal of relatively unimpeded international commerce will have been reached. I believe in these same goals; however, we must be realistic, and leave open the period of time during which we hope to attain them.

I commend the subcommittee, especially its chairman, Representative Reuss, for proposing such thoughtful and provocative reforms in the international monetary system at this time, and I hope that the IMF Conference will start debate on them at its forthcoming annual meetings. Such thinking and planning at the highest level is vital to our Nation's and the world's future economic viability, and is long overdue.

JACOB K. JAVITS.

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