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THE INTERNATIONAL MONETARY FUND: REFORM WITHOUT RECONSTRUCTION?

ALEXANDRE KAFKA

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

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The author, Alexandre Kafka, is a Brazilian economist. He currently represents his own country, Colombia, the Dominican Republic, Guyana, Haiti, Panama, and Peru in the International Monetary Fund and was a Vice-Chairman of the Deputies of Committee (of Twenty) for the Reform of the International Monetary System from 1972 to 1974. He also teaches international economics at Boston University. He was previously Director of the Brazilian Institute of Economics of the Getulio Vargas Foundation in Rio de Janeiro and has also lectured at the University of Sao Paulo, the Federal University of Rio de Janeiro, and the University of Virginia. Among his contributions to both U.S. and Latin American publications in the areas of international finance and economic development is his previous Essay (No. 94) in this series. The opinions expressed do not necessarily reflect those of the countries the author represents nor those of the institutions with which he is or has been associated.

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PETER B. KENEN, *Director*
International Finance Section

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The International Monetary Fund: Reform without Reconstruction?

The attempt at wholesale reform of the international monetary system, which started formally in September 1972, has come to at least a provisional close with the adoption by the Board of Governors of the International Monetary Fund (IMF) of the Second Amendment to the Articles of Agreement, based on the accord hammered out at Jamaica by the Fund's Interim Committee. In this essay I examine the significance of the reform exercise and the reasons for its apparent failure, and reflect on the further development of the system.

An earlier limited reform embodied in the First Amendment of the IMF's Articles of Agreement, ratified in 1969, was designed to supplement monetary gold stocks by the Special Drawing Right (SDR). The underlying purpose was to achieve at least a measure of international control over the growth of international liquidity. The creation of a new primary reserve asset issued by the IMF was expected to reduce the need for further accumulations of reserve-currency holdings, particularly U.S. dollars. The reduced need for dollars was also expected to improve the balance-of-payments adjustment process by reducing the need for, and therefore the ability of, the ultimate reserve center, the United States, to run deficits. These expectations were not realized. The United States continued to run large balance-of-payments deficits, and these led to the suspension of dollar convertibility into gold. This development reinforced the conviction, which the international financial community had increasingly felt for other reasons as well, that the existing international monetary system was contributing to the difficulties of balance-of-payments adjustment. Hence the decision to attempt wholesale reform.

While the origin of the reform exercise was dissatisfaction with the adjustment process, and in particular with the exchange-rate regime, the exercise was also concerned with convertibility and the settle-

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ment of imbalances and, once again, with international liquidity. Moreover, since a well-functioning international monetary system is not an end in itself, other matters were taken up at the same time. It was agreed in principle that the reformed system should promote the transfer of real resources to the less developed countries and that parallel improvements should be made in the trade regime. These were mainly, but not wholly, to be left to the "Tokyo Round" of GATT negotiations.

Before the reform exercise started, the IMF had prepared two reports on the subject. The 1970 report was concerned solely with the exchange-rate regime. It endorsed the use of par values and rejected outright prolonged floating, substantially wider margins around par values, and the "crawling peg." It mentioned but stopped short of endorsing three methods of improving the existing par-value regime: prompt(er) adjustment of par values, slightly wider margins, and temporary floating. The second report, published in 1972, discussed not only the exchange-rate regime but also convertibility and the settlement of imbalances, the problem of the coexistence of several assets in countries' reserve holdings, special problems posed by disequilibrating capital movements, and the relationship between international monetary reform and the developing countries. This report also endorsed the par-value system and, like its predecessor, made no definite recommendations for its improvement. There could be discerned, however, a slightly more positive attitude toward temporary floating and toward the special needs of the United States to acquire greater freedom effectively to change its exchange rate. Furthermore, two new ideas were mentioned: reform of the existing convertibility system through adoption of asset settlement, i.e., the view that all countries, including the United States, should be required to settle their balance-of-payments deficits in reserve assets, and the idea of a substitution account through which the IMF could issue SDRs to replace reserve currencies or gold held in members' reserves.

To draft the reformed Articles of Agreement, the Fund, on the recommendation of the 1972 report, established the Committee of Twenty, which in June 1974 ended its work with the presentation of an *Outline of Reform*. The first part of the *Outline* reflected the Committee's general view on the shape of the future international monetary system; there were numerous unresolved issues and this part, formulated by the Committee's "Bureau," was not endorsed in detail by the Committee. The second part of the *Outline* contained recommendations for immediate action that were endorsed by the

Committee. Adopting one of these recommendations, the Fund established an Interim Committee to advise the Board of Governors, *inter alia*, on monetary reform. What is the nature of the partial reform that has just been approved?

The Nature of the Partial Reform

Adjustment. The partial reform (the Second Amendment to the IMF's Articles of Agreement) legalizes the present exchange-rate regime in all its bewildering variety. This may be its chief contribution to the improvement of the international monetary system. For various reasons, but aptly, the proposed amendment finds no more precise way of describing the exchange-rate regime than "the one in force at January 1, 1976." However, the exchange-rate regime is by no means the only aspect of the monetary system that may affect the proper functioning of the adjustment process (except perhaps under completely freely floating rates that are not influenced by intervention or any other means—a regime that emphatically does not exist today).

The underlying problem is not just mechanical; it is the lack of sufficiently strong incentives to adjust, particularly to eliminate a surplus or, in the case of an ultimate reserve center, to eliminate a deficit. It is obviously desirable that countries in surplus and a reserve center in deficit should share in the political burden of initiating adjustment (all must share in the economic burden of the process once it is under way); otherwise, the start of the process is likely to be delayed. And the problem persists because the present regime is not one of completely free floating but of more or less intervention, not to speak of other forms of interference.

In principle, it appears easy to subject an ultimate reserve center to a strong incentive to adjust when it is in deficit, even when other countries are prepared to accumulate its currency despite the absence of any legal obligation to do so. It is necessary only to eliminate or reduce through reform of the settlement system other countries' freedom to accept the reserve center's currency liabilities, thereby forcing it to meet its deficits by drawing down its assets. Yet the partial reform does not deal with the matter. Nothing different could have been expected for the time being, in the absence, under present conditions, of defined obligations to intervene except to avoid disorderly markets. But nothing is foreseen specifically, either, if and when there is agreement on intervention with greater scope than at present. Thus, the dollar remains as firmly established as it has been

since the end of convertibility into gold as the world's main, or even for practical purposes sole, reserve asset.

There are, to be sure, even in the absence of a reformed settlement system, incentives for an ultimate reserve center to attempt to adjust, in particular the effects on its international competitiveness and employment if its balance of payments remains in disequilibrium for too long. But for a reserve center willing to continue to finance its deficits rather than adjust them, there is nothing like the compelling force of a reserve loss and of increasing difficulties in ordinary borrowing from the market, through central-bank swaps, or from the Fund. The reform of the settlement system would make less difference for the United States, the world's major economy, than for an ultimate reserve center in a different situation. But for any ultimate reserve center one can hardly doubt that the monetary-reserve function of its currency enables it to borrow more on any given terms than another similarly situated country whose currency is not held in reserves, at least in the absence of a perfect capital market.

To provide an incentive for countries in surplus to adjust is even more difficult in principle than to do so for reserve centers in deficit. There are, to be sure, disagreeable consequences of delaying adjustment even for countries in surplus, in particular inflation, but they are insufficiently brutal. The existing Articles of Agreement contain a specific sanction against countries persistently in surplus, the so-called "scarce-currency clause," and there are other sanctions that could be used against them (as against countries in deficit), for instance, the publication of a report that could unleash the forces of speculation against a recalcitrant sinner. None of these instruments has ever been applied. It is hard to apply any sanction against a country in a strong international position, and the difficulty increases with the extent to which the sanction is discretionary.

It was for this reason that the Committee of Twenty set out not only to establish additional sanctions (politely called "pressures") but to invent a new type of incentive to adjust that was expected to be particularly useful in its application to countries in surplus (although it would apply also to countries in deficit). Neither the additional sanctions nor the new incentives have been incorporated in the present partial reform, and at times there may be no way to persuade countries in surplus to allow adjustment to be initiated by refraining from intervention before they themselves deem it necessary to do so.

There was, first, a proposal to establish "objective indicators," the movement of which could subject a country to an obligation to take adjustment action. Since the obligation would be created not by dis-

cretionary assessment but by measurable facts, by whose verdict each member of the Fund would have agreed to abide, the idea was that the movement of objective indicators would establish a strong political argument for countries to fulfill their adjustment obligations even in the absence of sanctions. But it would also be easier to impose sanctions if they were called forth by measurable facts. Yet none of the various suggested indicators, including changes in the levels or flows of a country's reserves, commended itself to the Committee sufficiently to justify even the creation of a rebuttable presumption that adjustment was required—still less an automatic obligation, which nobody had suggested in so many words. The advantage of reserve indicators would have been particularly great if they had been reliable and effective, for they would automatically have prevented a surplus country from delaying its part in initiating adjustment action until it had reached what it regarded unilaterally as the limit of its holdings of reserve currencies.

Under these circumstances, the Committee of Twenty was led to suggest that the movement of indicators might trigger an *examination* of the balance of payments of a country. The IMF already examines its members annually (in principle). In addition, two or three times a year it analyzes the world economic outlook and, in this context, the balance-of-payments behavior of the countries that contribute most importantly to that outlook. Something was lost, however, by failing to adopt the Committee's suggestion that a statutory system of examinations be triggered by objective indicators. Such a system could still be established by decision rather than formal amendment of the IMF's Articles of Agreement, but it would not have the same force. Something was also lost at least marginally because the partial reform made no provision to apply to countries in surplus the additional pressures that were mentioned by the Committee. These included charges—or a tax—to be imposed automatically on reserve accumulations above a certain level, and the requirement that reserves above a specified level be deposited in the Fund at a zero interest rate.

In sum, the main defect of the partial reform in respect of the adjustment process in general is that it does absolutely nothing to create additional incentives for prompt adjustment action by reserve centers in deficit or by countries in surplus, however slender the chance of doing anything effective about the latter. No one can realistically maintain that the various general obligations (e.g., to promote stable underlying conditions) inscribed in the partial reform are a substitute even for minimal incentives. In connection with the possible reestablishment of a par-value system, the partial reform does explicitly

require provisions for prompt and adequate adjustment action by countries in deficit and by those in surplus, but these provisions are not defined. And, under more or less managed floating, additional incentives toward adjustment are also desirable, and they are not provided in statutory form.

What about the mechanics of adjustment? The compromise solution on the exchange-rate regime endorsed at Jamaica—the ratification of what exists and, in addition, rules to make possible without a new amendment the adoption of any other kind of regime—seems to be the only realistic one. By the time the reform exercise began, the original par-value system had been changed drastically. Most industrial countries did not declare new par values after the period of floating started in 1971 by the U.S. suspension of convertibility into gold; rather, they declared central rates, i.e., rates they intended to defend in the exchange markets but without any commitment even to their medium-term stability. In addition, countries not involved in the European "snake" enlarged the amount of fluctuation they would tolerate around the established values (whether par values or central rates); margins were set at 2.25 per cent in terms of the intervention currency, as contrasted with the previous maximum margins of 1 per cent and the effective margins of 0.75 per cent that had prevailed for some major members before the U.S. suspension of convertibility. Finally, at the time of the start of the reform exercise, one major currency, sterling, was floating again, and within six months, after a second devaluation of the U.S. dollar, all major currencies were again afloat.

What is surprising is that it took three years to reach a not very sensational agreement on the exchange-rate regime, apart from the merely semantic accord quickly achieved in 1973 (on the basis of an expression used in the 1970 report) that the future system should be based on "stable but adjustable" par values, with floating allowed "in particular situations."

Notwithstanding the ratification of the present exchange-rate regime, the partial reform provides that a par-value system may be reestablished by an extremely high majority of total voting power in the IMF (85 per cent, which gives the United States in isolation a veto), if the IMF finds that conditions are favorable, with special reference to the underlying stability of the world economy, provision of liquidity and arrangements for prompt and symmetrical adjustment both by countries in surplus and by countries in deficit, and arrangements for intervention and the treatment of imbalances. Even then, however, no country will be forced to adopt a par value, and any country may

abandon it once it has accepted it unless a similar major majority objects. A new par-value system would differ from the old in two aspects: its "normal" margins would be 4.5 per cent, and they would be flexible. (Also, the denominator or numeraire would not be gold or currencies and, to avoid confusion, may not be called SDR.) The Fund is also called upon explicitly to discourage unrealistic par values. It has always tried to do so, but the previous statutory emphasis was exclusively on discouraging competitive depreciations. All countries will be obliged to cooperate to maintain orderly exchange arrangements and to promote adjustment.

Other exchange-rate regimes that are neither the present one nor the par-value system may be established by an 85 per cent majority, but no country can be required to adopt such a regime. The power to establish other exchange-rate regimes may prove to be the most useful provision. It may make possible a temporary generalized "central-rate system" without (or with very wide) margins, which may be a more orderly substitute for the present system of discretionary managed floating (and, if a return to par values were possible, might be an essential starting point). Thus, a system of "viscous" rather than rigid or highly flexible rates might gradually come into being, as suggested at one point by President Giscard d'Estaing.

The compromise also contains a call upon the Fund to practice not just surveillance but "firm" surveillance over countries' exchange policies and for this purpose to establish "principles." Such principles, or guidelines, are obviously essential to prevent abuse under the present multifaceted regime, just as under a par-value regime—which differs from managed floating only in degree—the Fund has and must have the power to object to par-value changes and, ideally, to the maintenance of par values that have become disequilibrating.

Guidelines for floating currencies (as distinguished from principles that will apply to other regimes as well) were first established by the Fund in 1974. Most of these guidelines deal with intervention. First, there is the expectation that a country will intervene to moderate sharp, short-term fluctuations (day-to-day and week-to-week). Also, a country need not refrain from intervening to moderate slightly longer-term movements (month-to-month and quarter-to-quarter). It should, however, avoid moving the exchange rate away from what might appear to be a medium-term equilibrium level. Countries are encouraged to undertake intervention only to offset temporary factors, and even then they should not intervene "aggressively," i.e., push a currency to fall or rise more rapidly, even toward an appropriate medium-term level. But if a country has agreed with the Fund on

a target rate or zone for its exchange rate, "aggressive" intervention in that direction is considered appropriate. The Fund, moreover, is given the right to encourage a country, overriding any other rules, to assist in moving its exchange rate toward a reasonable medium-term level. What it cannot do is what was done under the par-value system—to ask or require a country to hold any particular rate against strong market pressure. Members are also encouraged to discuss with the Fund desirable reserve targets—a remnant of the idea of a reserve indicator—and interventions would be tailored to these targets when the Fund encouraged such countries to intervene. Another guideline requires countries intervening to bear in mind the interests of other members, in particular those of the issuers of the currencies with respect to which they intervene and which they use for intervention.

The *Outline of Reform* had suggested additional guidelines dealing with the choice of intervention currency and with settlement involving a country that has a floating currency and an effective choice of intervention currencies. One of these additional guidelines suggested that such a country should buy the weakest currency and sell the strongest. A second additional guideline suggested that other countries should not intervene in a floating currency without the agreement of the issuer (except for minor transactions). In other words, third countries should not through their intervention frustrate the intentions of a country with a floating currency, and the logical conclusion is that under widespread floating no intervention should take place without the consent of all countries concerned, including the issuer of the intervention currency.

It is possible that the "principles" may become both more comprehensive and more efficacious than the present guidelines, since, under the partial reform, the IMF is given explicit power to make them mandatory; the guidelines, by contrast, are only hortatory. The Rambouillet agreement provides for a system of regular consultations between a limited group of countries, including consultations on exchange rates; it would appear, however, that this agreement does not (yet?) provide for guidelines for intervention, nor indeed clearly mandate intervention except for the prevention of "disorderly" markets.

In addition to the guidelines mentioned so far, which deal with intervention, there is also a guideline adopted in 1974 which deals with restrictions: countries with floating rates should avoid restrictions on all *current*-account transactions. This goes beyond the Fund's prohibition of current-account *payments* restriction, but it is hortatory, not

mandatory. The Fund may, in future, adopt a mandatory "principle" of a similar kind (in view of the difficulties encountered by the GATT in policing its own limitations on trade restrictions). The IMF extracted a promise to refrain from aggravating trade restrictions from members drawing under the Oil Facility (mentioned below) and has attempted to extract it also from others drawing on its resources. No action has been taken on the suggestion in the *Outline of Reform* that controls over *capital* transactions should not be used to maintain inappropriate exchange rates or to avoid appropriate adjustment action, and that controls, when they are used, should be administered without excessive complexity. While the effectiveness of the suggestion in the *Outline* is doubtful, the present situation leaves countries entirely free to impose capital controls for any purpose. Such controls were the answer of the original Bretton Woods Agreement to the danger that disequilibrating capital flows might pose to the par-value system. But it has proven difficult to make such controls effective or, to put the point differently, controls effective for this purpose would have to cover all exchange transactions and trade and would therefore be intolerable. Hence, it is not surprising that the partial reform eschews the *Outline's* somewhat meaningless references to measures countries might take to avoid or moderate disequilibrating capital flows.

Convertibility and the settlement of imbalances. The partial reform retains freedom of current payments and transfers from payments restrictions (Art. VIII, Sec. 2), except those authorized by the IMF. This provision affects private economic agents vis-à-vis their governments, establishing what is called "exchange-market convertibility." It also protects the official holder of another member's currency, for at least in principle he can sell those holdings for current transactions either directly in the markets for third currencies or to the residents of his own country, who can in turn convert them in the market into any other currency. Until August 1971, the United States stood ready to sell gold to and buy it from official holders,but this kind of convertibility is not necessary to maintain exchange-market convertibility. Insofar as use is made of it, it serves two quite different functions. First, it gives official holders of currencies a means of acquiring a primary reserve asset. Second, within the limits noted earlier, it may be a means of disciplining the United States as the ultimate reserve center. To discipline other countries that are not ultimate reserve centers, it is not necessary that official holders of their currencies be able to buy from them a primary reserve asset; the purchase of any reserve asset is sufficient.

From another point of view, even under the old par-value system there was never complete protection of an official holder of a currency either from exchange-rate fluctuations within permitted margins and par-value changes or from the imposition of restrictions (whether on current transactions with the agreement of the Fund or on capital transactions without it). The situation has not changed in principle but very much in practice, since previously the margins were narrow and par-value changes were rare for major currencies. The risks to which official holders are exposed have therefore greatly increased. But it is also true that there is no agreement at the present time on intervention or the obligation to intervene except to avoid disorderly markets (and intervention for this limited purpose does not lead to significant fluctuations of official currency holdings). Consequently, official holders find these risks tolerable under present conditions, since any increase in currency holdings (strictly speaking, any level of currency holdings) reflects decisions to intervene (or to refrain from reducing holdings by intervention) that are entirely voluntary.

There is no question that the complete silence of the partial reform on convertibility and asset settlement and on the related problem of intervention constitutes a major defect. It is not sufficient to note the need to solve these problems before any return to par values. Convertibility and asset settlement are problems not only from the point of view of a future par-value system but from the point of view also of any intensification of the scope of intervention. This fact cannot be too strongly emphasized. It was, indeed, stressed in the Program for Immediate Action of the Committee of Twenty, which envisaged no early return to par values and yet authorized the Fund to consult with countries concerned if accumulations of reserve currencies became excessive. Furthermore, Part I of the *Outline of Reform*, in one of its suggested guidelines that has not been enacted by the Fund, would give a country intervening with the consent of the issuer of the intervention currency the right to settlement of the official balances acquired through intervention, whatever that might mean under conditions of floating. Perhaps the consultations mentioned above—or even more stringent measures—can be imposed under the "principles" mentioned above (Art. IV). But they are not envisaged at this time.

The partial reform retains another convertibility provision (Art. VIII, Sec. 4) that has never been applied. It obliges a member to repurchase on demand its currency from another member, using SDRs (formerly gold) or the other member's currency (which would presumably be drawn from the Fund, giving the purchaser a primary re-

serve asset in the form of a reserve position in the Fund). The obligation is subject to restrictions, of which the most important is that the currency must have been acquired recently as a result of current transactions or that conversion is needed to pay for current transactions, and it is further limited by the right of the repurchasing member to buy the currency needed from the IMF. Under market convertibility there was and is no need for this provision to enable an official holder to convert its holdings, directly or indirectly, into other currencies. Furthermore, for as long as the United States stood ready to sell gold to official holders for dollars at par, there was no need for Article VIII, Section 4, even to enable official holders of dollars to obtain a primary reserve asset. The provision is useless in the absence (as at present) of agreed limits to exchange-rate changes.

Finally, the partial reform does nothing to deal with the dollar overhang, but the problem has probably been eliminated or at least substantially reduced by the devaluation of the dollar and by inflation. This need not be considered a major omission.

Liquidity. Under any system in which floating is not clean but managed, monetary authorities need international liquidity in one form or another. In fact, it is conceivable that floating may lead to an increase rather than a decrease in the need for liquidity, compared with needs under a par-value system, and it has apparently done so in a few cases, as has been shown by studies carried out in the Fund. Yet the partial reform has found no solution whatsoever to the problem of equipping the world with an adequate but not excessive supply of unconditional official international liquidity. It may appear that this is irrelevant, since reserves may be borrowed in large amounts from monetary authorities and, directly or indirectly, in the private capital markets. But the ability of a country to borrow is itself related to the country's net reserves, and the available volume of primary reserve assets and reserve-center currency liabilities affects countries' net reserves.

The partial reform, lacking provisions for asset settlement, contains no explicit provision to limit the growth of national-currency holdings as reserves. It does make some changes with respect to the SDR. It enables the Fund, without new amendments, to permit operations in SDRs between participants not explicitly prescribed in the Articles. Any official entity, but not private parties, may now be declared an SDR holder. The Fund is also given powers to abolish the so-called "reconstitution obligation"; a qualified majority is required, but lower than it was before. Still, the principle of need for use is maintained in the provisions for designation—the provisions under which the IMF

selects the member or members that are to exchange SDRs for currency when some other member has need to do so. (The provision is not retained in respect of consensual transfers, which can be entered into freely.) Finally, the acceptance obligation remains limited. Thus, the partial reform increases the usefulness of the SDR, but insufficiently to make it in effect the principal reserve asset of the international monetary system, even if this were otherwise possible. The valuation of the SDR was changed in 1974; it is now valued in terms of a composite of sixteen currencies, instead of the equivalent of a certain quantity of gold. Its interest rate, moreover, is determined by a formula designed to keep it below market rates, which themselves rarely reflect expected exchange-rate movements. These modifications do not rule out—they may indeed intensify—a desire to switch from SDRs into currency or vice versa. But since the Fund controls the use of SDRs in designated transactions through the requirement of a balance-of-payments need, and since even consensual transfers can take place only with other monetary authorities, the possibility of instability in the volume or composition of reserves arising from such switches is practically nonexistent and would be no problem even if the volume of SDRs were much larger than it is at present.

The provisional reform makes important changes with respect to the place of gold in the international monetary system, but they are not of a kind likely to promote the role of the SDR or to resolve any of the problems that the coexistence of gold and reserve currencies has created and may continue to create. The provisional reform abolishes the official price of gold and removes the obligation of countries to make gold payments to the Fund and to accept gold payments from it. Removal of this obligation, together with the sale of part of the Fund's gold, discussed below, is a step in the direction of removing gold effectively from the monetary system. But the abolition of the official gold price could conceivably have the opposite effect.

In a recent essay in this series (No. 115, April 1976, *Reflections on Jamaica*), several authors take different points of view on this matter. In my judgment, it is on the whole unlikely that the right to buy gold at any price, and therefore above the old official price, which monetary authorities will acquire through the abolition of that price will be sufficient to lead to widespread use of gold as a reserve asset. Such use would require in addition a pegged price or at least protection against a decline in price below the one at which the gold was bought. There is an agreement among central banks not to peg the price for an initial period of two years from the end of August 1975 and to refrain from gold purchases that would increase the combined gold stocks of these

central banks and the Fund, taken together. Although the meaning of "peg" is left ambiguous, it is at present unlikely that a sufficient number of important monetary authorities would agree in any sense to "peg" the price of gold by joint action. (There is also a clause in the partial reform requiring that members collaborate with the Fund in their policies respecting reserve assets in order to make the SDR the main asset, though the practical value of this provision has yet to be tested.)

Gold will most probably remain "frozen" as at present, rather than becoming a usable reserve asset, apart from being used as collateral for central banks' lines of credit. That the role of gold as a reserve asset is more likely than not to remain limited is fortunate. Otherwise, unconditional official international liquidity could increase violently and for the benefit of the few industrial countries that are the principal gold holders. It is also true that if substantial inflation should continue, even a new peg for the price of gold would lead to fluctuation in the usability of gold as a reserve asset and in the volume of international liquidity, since gold would again become frozen when the market price rose above the pegged price or an adjustment of the peg was expected.

Nevertheless, the failure of the partial reform to remove gold entirely from official holdings could easily be damaging to the international financial community unless there are supplementary agreements. As long as monetary authorities hold gold, the mere fact that a pegged price for official gold transactions could be established at any time could tend to prevent any new allocations of SDRs when the international financial community comes to decide that international liquidity is inadequate. The argument that a simple agreement among central banks to peg the gold price could overcome for the most important countries the lack of international liquidity could well prevent or at least delay decisions to increase owned (unconditional) liquidity through allocations of SDRs and to increase borrowed (conditional) liquidity through enlargements of the IMF quotas.

Special interests of the less developed countries. Notwithstanding the heterogeneity of the less developed countries' interests, several matters proved of particular interest to large numbers of them.

First, many less developed countries would have preferred the reform to offer strong incentives (even to establish an obligation) for an early return to par values, or at least to install a more viscous system of exchange rates among the major developed countries. They believe that the present system tends to produce exchange-rate fluctuations that are functionless from the medium-term point of view (even a

well-managed par value system, they concede, cannot avoid medium-term changes). Such fluctuations, moreover, create special problems for them, whether or not they peg to a major currency. To peg involves a disagreeable political choice and often creates balance-of-payments and internal stabilization problems. Not to peg (or to change the peg frequently) involves the need to formulate an explicit exchange-rate policy. (It has also been suggested that it may be necessary for a less developed country floating independently to create a forward market, with high operating costs due to diseconomies of small scale, whereas previously, when all currencies were pegged to each other, hedging was unnecessary. This problem exists even if the developed countries' trade is invoiced in key currencies.) Unlike many developed countries, moreover, the less developed countries do not see the choice to be clear-cut between free trade and investment with floating rates and restrictions on trade and investment with par values. They point to the industrial countries' rather good postwar record of avoiding trade restrictions under par values and to protectionist lapses since the collapse of the par-value system, as well as to the fact that capital-account restrictions of the United States, the major capital exporter, exempted less developed countries to a considerable degree. (For a contrary view, see Nurul Islam in *Reflections on Jamaica*, this series, Essay No. 115, April 1976.)

A second concern of many less developed countries was to gain statutory recognition for their "special problems." In the first part of the *Outline of Reform*, there were several references to the need for special consideration to be given to the less developed countries in connection with the imposition of restrictions. These references, like the new provisions of which they were a part, have not been incorporated in the partial reform. Nevertheless, the partial reform does not prevent the Fund from applying a "rule of reason" (as it has always done, e.g., with respect to floating) and it does give special consideration to the less developed countries in connection with the transfer of real resources, discussed below.

A third concern of some less developed countries—the only one in which circumstances led to their full satisfaction—was to avoid restrictions on the ability of their central banks to deposit reserves in the offshore currency markets. Since less developed countries are net debtors on international account (in effect, their reserves are "borrowed"), they are particularly concerned to invest their reserves at the highest possible interest rate. This matter occupied an important place in the discussions on controlling international liquidity, but even the *Outline of Reform* failed to make firm recommendations.

As already mentioned, the promotion of the transfer of real resources to the less developed countries in the context of monetary reform was generally accepted as a goal from the outset, at least pro forma. One manifestation was the suggestion that the less developed countries be exempted from restrictions on capital outflows imposed by developed countries. Another was the general concern for the effects of the adjustment process on the transfer of real resources to less developed countries. Both were mentioned in the *Outline of Reform*, but only the second survives, and only as a task for the Interim Committee (or the Council—see below). In any case, the less developed countries concentrated most of their energies on the SDR link with development assistance. This proposal was in the end accepted or at least acquiesced in by all but two Members of the Committee of Twenty, the United States and Germany, but their opposition doomed it to failure. The argument most frequently mentioned in opposition to the link was the danger of undermining confidence in the SDR. Although proponents of the link had insisted from the outset that SDR allocations must be determined purely on monetary grounds, it was said that the link would lead to successful pressure by the less developed countries for excessive allocations of SDRs. It has also been suggested that the link would be inflationary even in the absence of additional SDR creation. It is true, of course, that any net addition to aggregate expenditure, for whatever purpose, is inflationary under conditions of full employment or labor-market pressure, but this is an argument against increased aid, not against the link as such; even budgeting aid expenditures does not ensure responsible fiscal management.

In view of the failure of the link proposal, the Reform Committee decided to recommend the establishment of a Joint Ministerial Committee of the Governors of the Bank and Fund on Development, alongside the Fund's Interim Committee. It was to make recommendations on ways to promote the increased transfer of real resources and on related issues. (The Interim Committee and Council are also to review the transfer of real resources to less developed countries, but only in the context of surveillance of the adjustment process.) In addition, with the support of the Committee of Twenty, a so-called Extended Fund Facility was established in the IMF to give balance-of-payments assistance with somewhat longer maturities than are usual in Fund drawings; this assistance is to go to countries facing the need for structural adaptation to deal effectively with their balance-of-payments problems. Since its establishment in mid-1974, however, only two drawings have been approved under this facility. One

should also mention in this context the liberalization of the Compensatory Financing Facility of the Fund, adopted in 1975, but this is coming under increasing attack from the largest members of the Fund. Other measures taken since the start of the reform exercise may be more clearly related to the oil situation or to other considerations than to the desire to increase the transfer of real resources to developing countries in the context of monetary reform. These include creation of the Fund's Oil Facility, a temporary increase in the size of the credit tranches, a modest increase in Fund quotas (the Sixth General Review), and the decision to establish a Trust Fund for the poorest of the less developed countries. The Trust Fund is related to the partial reform in that it is to be fed largely from the profits on the sale of one-sixth of the Fund's gold (except for the part of the profits imputable to less developed countries on the basis of Fund quotas, which are to be returned to them directly). The partial reform also envisages that capital gains realized by the Fund in selling the remainder of its gold may be used for financial assistance to the less developed countries. In this way, for the first time, the one-world principle which has characterized the Fund since its inception has been breached formally for the benefit of the less developed countries. It had been breached *de facto* by the decision to establish the Compensatory Financing Facility, which is reserved for primary-producing countries, but this was not a breach for the benefit of developing countries as such. The formal breaching of the one-world principle, however, can turn out in the long run to be detrimental as well as beneficial to the interests of the countries for whose apparent benefit the breaching occurs.

Other provisions. In addition to dealing with the international monetary system, the partial reform provides for a series of technical changes in the operations of the IMF as a credit cooperative or provider of conditional liquidity. It also introduces a few organizational changes (e.g., the power, with an 85 per cent majority of the total voting power, to replace the advisory Interim Committee by a Council with decision-making powers). But many questions have been left open, and numerous operational decisions have been made subject to qualified rather than simple majorities, which may make future management difficult.

Where does this leave the international monetary system and the IMF as an institution? A glaring illegality has been removed by the legalization of the present exchange-rate regime, since countries will no longer be obliged to maintain par values. But the partial reform

has left large lacunae in the statutory regulations pertaining to adjustment incentives, the settlement of imbalances, the role of gold, and liquidity in general, and these are important to the extent that exchange rates remain managed rather than being genuinely free from intervention and other interferences.

Decisions of the Fund can develop the system further in the future, as they have in the past, but this possibility is not a perfect substitute for more far-reaching statutory regulations. The legalization of the present regime is undeniably of some importance, since any juridical system is weakened by the presence of an unenforceable law. It must nevertheless be recognized that a system of par values, with its clear obligations regarding exchange rates, makes misbehavior easier to police even without sanctions than any system that has to apply necessarily complicated standards to exchange-rate policy. This is not, of course, an argument for an early return to par values. Nor is it, by itself, an argument for moving toward a system of more viscous rates, which would not be as difficult to police as the present system. It is simply a statement of fact that is relevant because the Fund has never had the power to impose material sanctions except upon members requiring access to its resources.

This last observation leads to another, concerning the shrinkage of the Fund's size in recent years in relation to its members' needs for financial assistance and to the availability of resources from other sources. The failure to reverse the shrinkage can be regarded as an aspect of the reform exercise. The entry into force of the recent Sixth General Review of Quotas, which resulted in a strikingly small increase in the size of the Fund, is linked to the entry into force of the Second Amendment. A Seventh General Review of Quotas is to take place within three years (instead of the usual five). But unless the next review brings about a large increase in quotas, the Fund will continue to be effective only with respect to countries which even today have recourse to it, essentially the poorer countries and others when in desperate straits, while its small size will continue to discourage still others—a group ordinarily comprising the main trading countries—from seeking access to the Fund and thus coming under its direct influence. The effect of the small size of quotas is not really offset by the developing practice of private bank syndicates of extending credit to countries in difficulties in reliance on a simultaneous standby with the Fund or on periodic Fund reports.

On the other hand, the Fund's technical prestige remains unimpaired. The opinions expressed in its consultations, even if not published, will continue to have some influence. By comparison with

their recent status, the partial reform will not have weakened the Fund or the international monetary system, and it will have created the conditions that may make it possible to strengthen them in the future. To say more, however, would be naïve.

The Failure of the Reform Exercise

One may ask why more was not accomplished and why the partial reform took so long—four years since the formal start of the reform exercise, six years since the Fund published the first report on reform of the exchange-rate system. The two questions are closely related.

The conventional reply is that there was too much uncertainty, especially after the oil-price increase; a learning period was needed that has not yet ended. Yet when the Bretton Woods Articles were formulated, in the midst of a war, there was even more uncertainty. A system was nevertheless formulated, though provision was made to bring it into effect only gradually, insofar as there was need for a transition. One could argue that at the time of Bretton Woods there was one dominant power, which had a clear view of what it wanted, while during the reform exercise there were several poles of power and perhaps none of them had a clear concept of what it really wanted in all respects. But it is just as possible that the real reason why no more was accomplished was simply that no compelling need was felt for anything more.

A review of the working of the international monetary system since the suspension of gold convertibility does not reveal a disastrous rise in internationally antisocial action. Economic rationality has grown since the thirties, and the habit of consultation fostered by a host of international institutions since World War II has done its part to accustom countries to have at least some regard for their neighbors' interests. Since governments believed that they could live with each other in a fairly civilized fashion even in the absence of a generally accepted law, those who felt that they benefited from the existing state of affairs were naturally reluctant to accept its early termination or even to spell out the details of the conditions under which it *might* (not must) in future be terminated. Those who felt they suffered were as reluctant to accept formal postponement of a change. The debate was thus less about substance than semantics and emphasis, yet feelings ran high. Fortunately, it has at least and at last been realized that total reliance on the continuation of a relative degree of good will without a generally accepted legal structure would be dangerous, and even an incomplete legal structure is better than none. The estab-

lishment of such a legal structure does not guarantee good behavior, but it does make it easier to pursue if desired.

Other explanations have been offered for the failure of wholesale reform and for the delay of partial reform. One of them compares the careful prenegotiation between the United States and the United Kingdom before the Bretton Woods Conference with the attempt to negotiate a reform from scratch in the Committee of Twenty. The Committee had two organs, the Ministers and the Deputies. Each of the twenty constituencies that appoint or elect an Executive Director in the Fund was entitled to as many as nine representatives in both organs. This format—a large itinerant international monetary conference having about two hundred participants at each level, with sixty entitled to speak at each level—was even more complicated than the format used at the technical level to produce the SDR amendment, the so-called Joint Meetings between Executive Directors and Deputies of the Group of Ten (the ministerial level being provided at that time by the Group of Ten). But none of this seems particularly relevant. If there had been either a genuine consensus or a dominant voice, the necessary texts could have been produced quickly by the Chairman of the Ministers and the "Bureau" of the Deputies (with three members from industrialized countries, including the Deputies' Chairman, and two from less developed countries, ably assisted by an economist from the Bank of England) or by the working groups on particular issues, which met between Deputies' meetings. In the SDR exercise, the size of the negotiating body was no obstacle, there being a far-reaching consensus.

It has also been claimed that the Committee of Twenty gave up too soon. This is not convincing, for all that the Committee of Twenty could have achieved could have been accomplished by the Interim Committee, which was practically identical in composition to the Committee of Twenty (it lacked the two associates for each constituency who had the right to speak at all times in the Committee of Twenty, and the Executive Directors and Fund staff and management performed the technical work). Closely related to this idea is the claim that the exercise started too late. One could say, rather, that the exercise started too soon. It was not more discussion but more experience with the economic conditions of recent years and the working of the post-1973 exchange system which was needed in order to formulate a statute for an international monetary system that was more comprehensive than the partial reform, yet sufficiently well adapted to existing and foreseeable needs so that it could endure—and do so, unlike the partial reform, not merely because it left essential matters without statutory regulation.

It is interesting, in this connection, to reflect upon some details of the reform negotiations, both in the Committee of Twenty and in the Interim Committee. Two basic issues dominated, and the failure to achieve even their partial resolution during the time the Committee of Twenty was in existence impeded progress with respect to other possibly even less controversial issues. The two issues were (1) how to formulate the legalization of the existing exchange-rate regime, including the conditions for an eventual return to a par-value regime and the characterization of the "particular circumstances" that would subsequently entitle a country to adopt floating, and (2) how to formulate the convertibility regime, or, in other words, the nature of the supposed discipline over the ultimate reserve center. Earlier, the basic disagreement had seemed to involve wider questions concerning the nature of adjustment obligations and convertibility, but on the first of those there had been some approach to consensus. (Another disagreement was about gold, which its adherents apparently wanted to preserve as a possible future substitute for dollars, in the absence of confidence in the SDR.)

The Committee of Twenty never came close to agreement on how to formulate the provisions for an eventual return to par values, for exempting individual countries from such a return, or for permitting them to abandon par values after they had accepted them, somewhat semantic though the problem was when all were increasingly in agreement that floating could not be abandoned very soon. (This became particularly clear after the oil-price increase but was appreciated even earlier.) On the second issue, however, when it was realized that the controversy about disciplining the ultimate reserve center by tightening the convertibility or settlement system was in reality semantic, at one point in September 1973 the Committee of Twenty approached tentative agreement, although failing to achieve it even contingent on agreement on the exchange-rate issue. (The convertibility in question here, of course, is not market convertibility but the disciplinary kind represented before 1971 by the ultimate reserve center's undertaking to convert its currency into gold for the benefit of official holders.)

The main discussion was between those who defended "general" convertibility or "convertibility on demand" and those who defended mandatory settlement in reserve assets by all countries (obviously, primary ones for the ultimate reserve center). The objection to convertibility on demand was the demonstrated ease with which a major reserve center can persuade holders of its currency not to request

conversion; it was believed—with some exaggeration, but not wholly fancifully—that convertibility on demand thus imposed little adjustment pressure on the reserve center and implied unlimited accumulations of international liquidity. Under the proposed mandatory system, the Fund would determine whether an excessive increase had occurred in the currency liabilities of any country and would then direct that country to transfer a corresponding amount of primary reserve assets to a Settlement Account in the Fund, which in turn would repurchase the corresponding currency balances from the countries that had accumulated them and would retransfer them to the issuer. In the event of a fall in currency liabilities, the Settlement Account would not operate with countries requiring balances of the currency in question; they would make their own arrangements with the issuer. (The mandatory system could also be run without a Settlement Account; the Fund would instruct holders of reserve currencies that had been accumulated in excessive amounts to present them directly to the issuer for conversion.) It was recognized, however, that if intervention was to take place in SDRs, countries' needs for reserve currencies would decline or disappear and provision for voluntary conversion would be quite adequate. On the other hand, if, instead of SDR intervention, a multicurrency intervention system was adopted (i.e., one in which intervention would not take place in a single currency but instead each participant would intervene in the currencies of all other participants), provision could and would be made for strict, quick settlement of currency balances acquired in the course of intervention or for the intervening country to borrow the necessary currency from the issuer so that no official balances of it would be outstanding. (This would, of course, imply that each country intervened only to prevent depreciation of its currency and not to prevent appreciation.) In any case, no single country would be *the* ultimate reserve center. (A country that had borrowed to intervene in order to avoid depreciation of its currency might subsequently elect to intervene in the opposite direction in order to acquire the borrowed currency—in preference to producing a surplus by internal policies—and thereby promote its own currency's depreciation. But there is no reason to assume that in such a system there would be either more or less competitive depreciation than under any other system.)

After much debate, a few practical points were accepted generally shortly before the September 1973 Annual Meeting of the IMF held at Nairobi. First, it was accepted (wrongly) that convertibility belonged only to the par-value system. Second and more important, it

was believed (probably also wrongly) that intervention in the context of a return to par values would tend to take the form of a multicurrency intervention system (an SDR system was considered impracticable) for the major countries, with strict, quick settlement obligations for the participants; mandatory asset settlement would thus be an automatic concomitant of the return to par values. It was not realized how complicated a widespread multicurrency intervention system would be.

The uncertainties created by the oil-price increase must be seen largely as a pretext rather than the cause for the failure to pursue more energetically the hints of consensus that had emerged before Nairobi. No hint of consensus had surfaced with respect to gold, which a few would have been prepared to sacrifice at all costs, some not at all, others only for the benefit of the SDR rather than the U.S. dollar, and still others only for the sake of the dollar and *not* the SDR. Furthermore, while there was substantive consensus that nobody wanted the early, widespread, organized termination of floating, the basic divergence persisted. The supporters of floating refused to spell out in detail the conditions under which it might be terminated; they feared that pressure to join in adopting par values would prevent them individually from availing themselves of the exemptions that would be written into the general conditions. And the opponents of floating did not want to agree formally to postpone its end for any considerable length of time.

As regards specifically the failure to meet the wishes of the less developed countries, it has been argued that monetary reform is not the appropriate framework in which to promote the transfer of real resources. Even if one accepts this argument, and it is not convincing to say that the monetary system should not be constructed in a manner designed to facilitate this transfer along with other objectives, it is also true that nothing much has been done recently within other frameworks to increase the availability of resources for transfer to the developing countries. The beginning of the reform exercise may have coincided with the end—or interruption—of an era of goodwill by important developed countries toward developing countries as a group. The oil-producing countries learned to give aid in commendable fashion once they had the resources, but they cannot alone provide the aid that is needed. It is possible, however, that the aid that was *given* by developed countries may in future be replaced by aid that is *negotiated*, as a consequence of the efforts of the developing countries to coordinate their positions vis-à-vis the developed countries. (In the interim, the offshore banks came to the rescue. They

acted neither out of the goodness of their hearts nor—as has sometimes been suggested—out of the softness of their brains. They were perfectly rational, for the great raw-materials inflation of 1973–74 had enormously reduced the burden of the existing debt for many developing countries and increased their capacity to add to their external debt.)

Outlook

In which direction is the system likely to develop in the future? Consider first the adjustment process. It is not likely that there will be any major change such as the establishment of an "objective indicator" structure to create a presumptive (but rebuttable) adjustment obligation. Such a structure might be established by decision rather than agreement, but only to trigger presumptively (and rebuttably) a special examination of a country's balance-of-payments position. In the main, adjustment will, as at present, be forced on deficit countries that would otherwise wish to avoid it by unemployment, reserve losses, or the increasing difficulties of borrowing. It will be forced on surplus countries by inflation. There may be some nudging by the IMF, based on its assessment of the situation and reflecting the opinions of other countries, each country's fear of the others, and the desire of all not to be unnecessarily beastly to each other. The influence of the IMF will be strongest over those countries that need its financial assistance and will therefore depend ultimately on the size of Fund quotas and on conditions of access to the Fund's resources. The Fund's power to publish reports on a country could exert some pressure for compliance with Fund advice by promoting currency speculation. But it is precisely the peculiar *modus operandi* of this power that makes it difficult to employ.

How about the exchange-rate regime? A close look at the present situation discloses something rather surprising. The par-value system is supposed to have been replaced by what is often called "generalized floating." Yet 97 of 129 currency areas registered by the Fund are described as pegging their currencies, and while 13 of 14 industrial countries are described as having floating currencies, 7 maintain among themselves a system of common margins, in essence a par-value system. (One should not underestimate, of course, the significance of the fact that 7 industrial areas, countries, or groups *are* floating independently.)

The present system—if we can call it that—has come in for some criticism. Some exchange rates have failed to move when equilibrium

seemed to require it. Some large bilateral exchange-rate fluctuations, by contrast, have served no discernible adjustment purpose from the medium-term current-account point of view. Even those bilateral fluctuations that offset differences in price movements were not necessarily helpful from the adjustment point of view, since the starting point of prices and exchange rates was not necessarily equilibrium and underlying conditions have been changing. It is sometimes emphasized that the fluctuations in effective exchange rates for individual currencies—fluctuations in relation to all other currencies taken together—have been much smaller. While this is true, it does not really meet the argument that the system did not work well; it is the bilateral fluctuations that matter to the individual trader, at least over the medium term. In the third year since the collapse of the Bretton Woods system, short-term fluctuations of both effective and bilateral exchange rates have been smaller than in the first two years (although they have still not been by any means unimportant). This fact may be due not only to a change in underlying conditions but also to progress in a learning process by operators in the market.

It is too soon to come to a conclusion on the efficiency of managed floating, but it may be mentioned that the criticism leveled against the system's operation, particularly during its first two years, can be reinforced by recalling that under the old par-value or central-rate system, even in the disturbed years 1971 and 1972 with all their exchange crises and the repeated closing of exchange markets, the real growth of the world economy and of world trade and payments does not appear to have been hampered. (It would be obviously unfair, however, to blame the slowdown since 1973 on the collapse of the par-value system.) Nor can one claim that inflation has been less since the beginning of generalized floating than under the par-value system that was so often accused of fomenting inflation. Even where currencies were floating more or less freely, nonspeculative capital movements may have frustrated the tendency of floating rates to bottle up inflation or deflation in the country where it originated by stabilizing current-account balances; capital flows to booming countries with large profit opportunities prevented the exchange rates of partner countries from appreciating. I do not suggest that the exchange rate is irrelevant; my doubts are not of the global monetarist variety. I do suggest, however, that recent experience raises questions about the relevance of the exchange-rate *regime* for the international transmission of disturbances and the medium-term adjustment process.

Whatever one's judgment on these issues, it is possible that the world may wish to move in the direction of a regime which, without

being a par-value system, might nevertheless establish more far-reaching understandings than now exist to limit fluctuations of exchange rates; one might call it a system of more viscous exchange rates. Such a regime would share with the par-value system the disadvantage that (some) rate changes might have to be made in discrete and therefore large steps. Crawling-peg systems have never been accepted by practitioners because these cannot guarantee the absence of the need for large discrete steps. And if such steps become necessary with some frequency, crawling-peg and par-value systems become not only unwieldy but meaningless; a par value that has to be changed every few weeks is not in practice different from a managed floating rate. Predictions about the actual behavior of exchange rates have therefore to depend on predictions about underlying conditions. Will conditions in future require frequent major changes in exchange rates? The new Article IV obliges members to conduct their policies so as to establish, as far as possible, stable underlying conditions. Nonetheless, there remains a major problem in this connection—the problem of strong inflation. If inflation even at the average rate presently prevailing in the industrial countries becomes acceptable, differences between countries' rates of inflation are likely to be proportionately greater, requiring larger and more frequent exchange-rate changes. (Such changes would be needed even if the differences were not proportionally greater. A 50 per cent difference in inflation rates between a country that inflates at 0.5 per cent and another that inflates at 1 per cent can be accommodated by internal policies; the same proportional difference between a country that inflates at 50 per cent and another that inflates at 100 per cent cannot be accommodated, and this is also true of considerably lower inflation rates.) Thus, the shape of the future exchange-rate regime will depend on how governments see the tradeoffs between unemployment and inflation and between growth and inflation; the fact that the industrial world has managed to traverse a rather severe recession without social unrest, owing to far-reaching social-assistance schemes, may bring the pendulum back to monetary stability in these countries. Isolated changes in competitive conditions between countries, as distinct from continued and general underlying monetary instability, can be accommodated by a regime that limits fluctuations much more than the present one. But frequent and wide swings in the prices of raw materials that weigh heavily in world trade may pose a problem for such a system similar to the problem posed by strong and continued inflation. Should underlying conditions become more stable, however, it might be possible to move to a more viscous system of exchange

rates, even if the new stability is still deemed to be incompatible with the restoration of a par-value system like that of pre-1971 days.

(The United States had a special objection to the par-value system. It felt that such a system did not give it the same freedom as other countries to devalue or, more generally, to change its effective exchange rate, because other countries would be likely to follow suit. While the first devaluation of the dollar was a dramatic and long-drawn-out affair, supporting the U.S. view, the second devaluation of the dollar in early 1973 was carried out smoothly over little more than a long weekend. Moreover, while the United States would be exempt from attempts to prevent changes in its exchange rate under a system of genuinely free floating, this would not be true for the United States or any other country under a system of managed floating. In fact, insofar as a system of managed floating is more difficult to police than a par-value system, it may be just as easy under managed floating as under a par-value system for a group of other countries to prevent a change in the effective rate of the dollar. Under a par-value system, they would have to convince the international community that they should be permitted to follow the depreciation or appreciation of the dollar; under a system of managed floating, they would have simply to agree to intervene in the market or to take other action to influence the exchange rate. It is also true that under the par-value system there was a tendency on the part of countries other than the United States to overdo devaluations, but this was the paradoxical result of the known reluctance to change exchange rates. A credible change had to be extreme. Now that exchange-rate changes have become accepted as less than catastrophes, there should be no such tendency to overdevaluation.)

What can be expected with respect to restrictions? The extent to which the Fund may be effective under managed floating in inhibiting the use of current-account restrictions will depend on the same factors mentioned earlier that will determine its influence on the adjustment process generally. It will be difficult, however, to police the proscription of capital controls (and other policies) that might be used to maintain unrealistic exchange rates even though manipulation of exchange rates to prevent adjustment is proscribed in the new Article IV.

What will develop in the fields of convertibility and settlement and the related area of the intervention system? I have already indicated that if intervention again became an obligation, other than for prevention of disorderly markets, countries might have to be protected against the risks of exchange-rate fluctuation that they face today

when buying other countries' currencies—even beyond the extent to which others' obligation to intervene itself might protect each country that intervenes. One way would be to avoid the holding of foreign currencies (by intervening only to prevent depreciation of one's own currency, with funds borrowed ad hoc). It might, indeed, be helpful to expand existing institutional arrangements for the borrowing of currencies. But exclusive reliance on intervention with funds borrowed ad hoc does not seem a practical proposition. It is hard to imagine that countries would feel comfortable enough with deficits of any size to run them for any length of time and finance them by borrowing. Adjustment could become excessively radical.

If, therefore, a more viscous managed float was desired, owned reserves would be needed, whether in the context of a single or a multicurrency intervention system. Consequently, it may be necessary to guarantee the exchange value of official currency holdings, i.e., to provide for some sort of convertibility beyond the one inherent in the viscous system itself. The applicable example might be the agreement with holders of sterling concluded after the second devaluation of the pound. And even if one sets little store by managed floating, it may not be safe to rely forever on good behavior to restrain central banks from currency speculation intended to protect the value of their currency holdings. An alternative solution—some time in the more distant future—might be an SDR intervention system. Such a system could be operated even if, as at present, SDRs could not be held by private agents.

(An SDR intervention system with this restriction was suggested in the Committee of Twenty by a United Kingdom representative, Mr. John Sangster. Under such a system, central banks would stand ready to sell SDRs against currency at specified rates, not only to each other but also on orders of commercial banks and, presumably, other authorized exchange dealers. The commercial banks would never actually hold SDRs but would immediately order their transfer to another central bank whose currency they needed to supply their clients.)

As distinct from a system of intervention based on a particular currency, a system of SDR intervention assures automatically the symmetry of margins between all currencies. (Symmetry can also be assured by a system of multicurrency intervention under which each participating country regards the currencies of all other participating countries as intervention currencies, but the practical difficulties of running such a system on a worldwide basis have already been mentioned.) The asymmetry of margins was one of the U.S. objections to

the old par-value system, but asymmetry arises from the intervention system, not from the exchange-rate regime.

To function well, any convertibility or asset-settlement system will have to be endowed with elasticity; to this end, a series of useful ideas from the *Outline of Reform* may well be revived. Thus, normal settlement arrangements might be temporarily suspended. It would also be necessary, however, to have a weapon against a country in surplus that refused to play its part in the adjustment process—a way to limit its future accumulations of surpluses. This would be particularly necessary if a country accumulated surpluses in a system without mandatory convertibility; the issuer would be encouraged to consent to the continuation of its deficits. One way to exert pressure on such a surplus country would be to establish a limit on holdings of primary assets beyond which the surplus country would have no right to demand, and the issuer no obligation to agree to, conversion.

"A quelque chose malheur est bon," and one may therefore hope that the ongoing inflation will finally eliminate what may still remain of the so-called dollar overhang. If it does not, one might have to return to the Committee of Twenty's idea of a Substitution Account (which could be merged in practice with a Settlement Account as well as a Gold Substitution Account—see below). That Account would issue SDRs against currencies transferred to it, acquiring in return a claim on the issuer. Difficult problems arise, however, with respect to the nature of this claim, the interest if any to be paid on it, the obligation if any to amortize, and the maintenance of value.

What is apt to happen in the domain of liquidity? As I have already indicated, the need for owned liquidity is not likely to disappear. There seem to be two basic obstacles in the way of a satisfactory solution. The first is the gold problem, which the partial reform has left in a most unsatisfactory state that could easily prevent the possibility of adequate but not excessive increases, particularly in owned but possibly also in borrowed liquidity. The second is the problem of excessive liquidity creation by other means.

It has been suggested that one way to solve the gold problem would be to establish a Gold Substitution Account at some future time. Such an Account could acquire gold sold to it voluntarily and at market price, replacing it with a special issue of SDRs. The Account would enable monetary authorities holding gold to acquire a usable reserve asset, so that gold substitution would solve the problem of instability in liquidity (i.e., periodic increases in total liquidity through gold revaluation and periodic decreases through the freezing of central banks' gold holdings due to expectations of an increase in the gold

price). It would do so, moreover, without prejudice to the SDR. A Substitution Account would attribute a certain value to gold holdings, which at present have a very uncertain one, with, recently, a declining tendency. Thereby it would effectively increase the amount of owned and unconditional liquidity, perhaps excessively; and since gold, as already mentioned, is largely held by a few countries, there would be danger of a maldistribution of liquidity. Excess liquidity could be attacked by requiring countries turning gold into the Substitution Account to agree to receive SDRs only for part of the gold, the rest being issued to them only as overall liquidity needs dictated. Maldistribution could be attacked by turning over to member countries not holding gold some of the SDRs corresponding to the value of the gold surrendered to the Account.

(Other concerns relating to a Gold Substitution Account are less relevant. It has been suggested, for example, that the establishment of such a facility would be incompatible with the gradual phasing out of gold because it would tend to establish a reference price. This would be true only if the Account were an open-ended facility, if monetary authorities could at any time present gold for substitution at the agreed price. If the Account were open only on one occasion, it would not be able to sustain the gold price at any level. It has also been suggested that a Gold Substitution Account would unavoidably involve the Fund in the management of the gold market, since the Fund would presumably wish to sell its gold to private holders and would have to calibrate the pressure it wished to exert on the market. This problem would be of concern not only, or not so much, to central banks holding onto their gold but also to countries desiring to protect private holders. But if all other conditions of gold substitution were fulfilled, the Fund could be trusted to manage its gold in a reasonable manner.)

There is no provision for a Gold Substitution Account in the partial reform and no provision by which the Fund could issue SDRs in any other way than to all participants in the Special Drawing Account in proportion to quotas. A new amendment would therefore be necessary, unless by agreement a different solution could be found within the amended Articles. It is clear, in any case, that gold will not be replaced by SDRs unless and until the conviction is widespread that gold will not become usable as a reserve asset and there is greatly increased confidence in international institutions. Fortunately, gold substitution is not the only solution to the gold problem. It may be sufficient and possible to obtain an indefinite extension (under Art. VIII, Sec. 7) of the voluntary two-year pledges of the Group of Ten

countries that they will not attempt to peg the price of gold or to increase their own and the IMF's combined gold stock, supplemented by further pledges that the combined gold stock will gradually be reduced and that countries will not use gold in bilateral settlements without permission of the IMF. The recent fall in the gold price may increase the pressure on major central banks to agree to peg the price at least for transactions among themselves; if the price remains low and fluctuating, it might also increase the willingness to contemplate establishing a substitution account.

The second liquidity problem has several dimensions. There is first the problem of reserve-currency accumulation, which could again become critical in the context of more active intervention without adequate settlement provisions, particularly in a single-currency intervention system, and in the absence of an adequate adjustment process. The recent increase in reserve-currency holdings has been concentrated mainly in the hands of OPEC countries, where these holdings have a somewhat different character and impact than usual. There is, second, the problem of reserve creation by borrowing arrangements between monetary authorities. Little concern is generally expressed as to its dangers, perhaps because it is believed that national monetary authorities always act with prudence when lending explicitly (rather than buying currencies). But excessive liquidity can be created even if the international monetary system is run as a credit-card economy rather than a cash economy. The international monetary system would in that case have leaped from commodity money and goldsmiths' I.O.U.'s (i.e., the gold-exchange standard) to the credit card, passing through the paper (and bank deposit) stage in the form of the pure dollar standard. (The SDR, which would have represented a more rational form of that stage, would then have been an instrument invented *after* its time had passed.) The central banks would be the issuers of credit cards. A third problem is reserve creation through the offshore-currency markets, a problem that remains so long as central banks are free to deposit their currency reserves in those markets. The scope for money creation in the offshore markets is an unresolved issue, but few doubt that it would be extremely limited in the absence of central-bank deposits. The less developed countries are opposed to limiting central-bank deposits in the offshore markets, with their relatively high interest rates, but a rule of reason could continue to prevail whereby the major holders of reserves continue to refrain from depositing them in offshore markets. The IMF's new powers (Art. VIII, Sec. 7) could be used to enforce such a rule.

Once these matters had been dealt with, the provision of uncondi-

tional liquidity, as well as conditional liquidity, could be left respectively to the SDR system and to periodic, realistic increases in IMF quotas. Even if SDR creation were inhibited by lack of confidence in the SDR as a form of unconditional liquidity, increases in IMF quotas might be possible, precisely because of their conditional nature, which reassures those who are afraid of too much liquidity and appeals to those who wish to offer incentives to international cooperation in the monetary field by giving the Fund more influence, at least over countries in deficit.

From the point of view of the developing countries, increasing the size of IMF quotas may also prove more attractive than the recent substitute, the creation of special facilities, including those addressed particularly to them. Special facilities for a specific group of countries are apt to have strong conditions attached to their use, and this tendency is likely to be reinforced because the liquidity of the IMF is itself limited, so that special facilities cut into the resources available for the membership in general or have to be financed by borrowing from lenders who are likely to impose special conditions. Furthermore, the failure to increase Fund quotas adequately—in relation to world trade, they are now between one-third and one-half of what they were in the fifties and have never been lower—will reinforce the tendency of the Fund to become the pawnbroker to the poorest or most mismanaged economies; the healthier part of the world, lacking interest in the IMF's practices, is therefore likely to encourage the imposition of increasingly strong conditions, even on the Fund's ordinary credit. By contrast, an increase in the IMF's importance as an international credit cooperative would require a change—not necessarily the liberalization in all respects—in its operating practices, to make its assistance available more speedily where needed.

Such a development would be highly desirable in a period during which there may be more concern in the major countries for monetary stability than for employment and growth, so that internal economic stimuli whose balance-of-payments effects must be offset by price-raising devaluations or restrictions appear particularly unattractive. There appears, in addition, to be a closer synchronization of the phases of the business cycle in the major countries, so that a shortage of liquidity, inhibiting an increase in imports, may lead to vicious circles inhibiting recovery. It remains to be decided whether such an enlarged Fund should continue to be run on the basis of contributions in national currencies. This practice makes it impossible to gauge precisely the Fund's ability to assist its members (its "liquidity"). An enlarged Fund might instead be based on SDR issues, so that a coun-

try's access to IMF resources would be limited only by the Fund's rules, not by its "liquidity." This issue, however, may be decided only at a much later stage.

What of the link? The effectiveness of the link as a means of providing additional development finance cannot be taken for granted. If no SDR issues take place, the whole mechanism will be useless. And even if SDRs are created, it is at least conceivable that the effect of the link will be offset by a reduction in other types of official development assistance. As these presently amount to over 5 per cent annually of outstanding reserves, there would be ample scope for offsetting the effects of the link unless SDR allocations went into high gear. Not quite convincingly, it has been argued that parliaments, not governments, are the ones that have become skeptical about additional aid, so that a mechanism like the link which could obviate the need to appeal to parliaments would be more likely to generate additional assistance. It has also been suggested (originally by Geoffrey Maynard) that link aid, being, as it were, given collectively by the entire group of developed countries, would be expected by each individual country to have less impact on its balance of payments than an increase in bilateral aid and that additional development assistance through the link would consequently not be as worrisome to donors or as likely to be offset by a reduction of other aid. But the link is not the only way to increase aid multilaterally.

It is also clear that even if SDRs came to pay an interest rate more competitive than at present with those of the private markets, link aid would still be useful to less developed countries that cannot borrow in the markets; moreover, one form of the link—SDR allocations to less developed countries in larger proportion than their quotas—has a maturity which is limited, in the absence of "reconstitution," only by the recipient's ability to run a balance-of-payments surplus. In sum, it is clear that the link can guarantee nothing to the less developed countries but equally clear that it poses no danger either to them or to the developed countries.

In an essay published in this series before the formal start of the reform exercise (*The IMF: The Second Coming?*), I concluded that the world might move either to a reconstructed par-value system with greater flexibility of exchange rates or to a system of currency blocs—not necessarily hostile ones—within which exchange rates would be pegged and between which they would float—not necessarily freely. While some major currencies are floating independently and there is the new, but limited, phenomenon of pegging to baskets of currencies, including the SDR, nonhostile currency blocs of the

kind described have become important, with the dollar bloc increasingly dominant in terms of numbers of countries. Except for a group of European countries, the blocs mostly consist of a developed country and a number of developing ones, or only of developing countries. There are signs of dissatisfaction, however, with the amplitude of fluctuations between individual currencies and between blocs, signs of disintegration within the European bloc, and calls or at least expressions of hope for a more viscous system of exchange rates. The further evolution of the system may take place purely through decisions of the Fund rather than through additional amendments, but some essential developments may be almost impossible to achieve without a further change in the Articles of Agreement.

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