

ESSAYS IN INTERNATIONAL FINANCE

No. 53, April 1966

PROBLEMS OF THE
INTERNATIONAL MONETARY SYSTEM

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the fifty-third number in the series ESSAYS IN INTERNATIONAL FINANCE published from time to time by the International Finance Section of the Department of Economics in Princeton University.

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Princeton University
L.C. Card 66-21796

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

PROBLEMS OF THE INTERNATIONAL MONETARY SYSTEM

For more than five years there has been a stream of discussion and reports on the functioning of the international monetary system. The system has been charged with having a variety of ills, and a variety of plans have been offered for reforming it. Now, the Group of Ten countries are engaged in discussions to see what basis for agreement can be reached on improvements in the system, and it is expected that their report will be available before the next annual meeting of the International Monetary Fund. Thus, it seems that the moment of truth has arrived—the time for crystallizing all this debate and for deciding on the practical course of action for the future.

It is not the aim of this paper to review all the alleged faults of the system and plans for reform; this could lead to endless detail from which clear conclusions would be unlikely to emerge. Rather, I propose to put in sharp focus the key problems that governments have been arguing about and to try to distil from actual experience the reality of those problems.

It is well to admit at the outset that this is a difficult subject—which should be evident enough from the diversity of views that intelligent and well-meaning men hold about it. For one thing, as I will try to show shortly, it is difficult because in practical affairs the problems of the system present themselves mixed together; yet, to deal with them effectively, they must be rigidly separated in analysis and treated by different kinds of policy action. It is difficult also, because the appropriate measures for dealing with the issues that arise are seldom simple matters of right or wrong: besides technical analysis, the issues demand wise judgments which in the end involve the kind of trading and financial world we want to have—and even the power and sovereignty of nations. Mutual understanding and cooperation among the principal countries are needed every step of the way.

THE OFFICIAL VIEWPOINTS

The main official study of the system has been by the Group of Ten—that is, the ten industrial countries participating in the General Arrangements to Borrow of the International Monetary Fund. The study was initiated at the IMF meeting in Washington in September 1963, and the Report of the Deputies was published in August 1964.

This report ostensibly deals with the longer-term problems of the

system, but it was understood by all the participants that any arrangements made for the future would have practical implications for the present. Under the circumstances of a continuing U.S. balance-of-payments deficit, many of the countries were reluctant to make future commitments which might in practice have helped to perpetuate that deficit. While the report is expressed in negotiated language, it still makes clear that the countries have quite different attitudes about the present functioning of the system. The report says that the system has shown great flexibility in the face of changing conditions and that the volume of international liquidity is fully adequate for present needs. Despite these soothing words, it is difficult to read it without getting the impression that some action is needed to improve matters but that there is dispute about what that action should be.

In the end, the Group of Ten did compromise on two concrete steps. First, the countries agreed to support an increase in IMF quotas; the general increase of 25 per cent, that has now been negotiated, was a compromise between the much larger and much smaller amounts that the various countries really considered necessary. Secondly, the Ten agreed that Working Party No. 3 of the OECD should in the future exercise multilateral surveillance over the financing of balance-of-payments deficits and surpluses. Working Party No. 3 was to be helped in this task by new information collected by the Bank for International Settlements and by discussions among the BIS Governors at their monthly meetings. The compromise on this step, aimed at securing stricter standards of financing, was intended, at least by some of the countries, as a counterbalance to the increase in quotas. I believe it has been useful, not only in providing better data on current developments but in helping to focus official discussions on the essential points. As one may imagine, however, with sovereign countries involved, the "multilateral" part of this exercise has proved to be much easier than the "surveillance."

On two important questions, the Group of Ten was unable to reach agreement during their year of discussion, and these questions were passed on to study groups. The first group, with Mr. Ossola as Chairman, published a report dealing with possible new reserve assets. This report clarifies the nature of the various proposals that the group reviewed, but it shows little progress in resolving the differences among the countries on what type of assets may be most appropriate. The second group, dealing with the ways and means of improving the process of adjusting deficits and surpluses, is still at work. But, as most countries are wary of making commitments on adjustment policies, it will be difficult for the group to reach effective conclusions.

Thus, it may be seen that official discussions have revealed basic differences of viewpoint. On the surface, it would appear that the disagreement is about what improvements may be needed in the international monetary system in the future. Behind this, however, the fundamental debate is on what the real problems of the system are, here and now. Obviously, so long as there is disagreement on the essential problems, there is little chance of reaching agreement on their solution.

The crux of the dispute is concerned with the nature of the payments imbalance, with the argument concentrating on the persistent deficit of the United States. To oversimplify somewhat, there are two opposing points of view. One side believes that balance-of-payments deficits can usually be corrected only over a rather long period of time—particularly since the surplus countries are not under the same pressure as the deficit countries to assist in the adjustment process. This side considers that to take measures to correct a deficit which interferes too much with internal economic growth is to get the priorities wrong, and that measures likely to lead to internal deflation or unemployment are not to be tolerated. Moreover, at least some of the countries on this side have been reluctant to invoke controls over capital movements to help restore equilibrium, and they just about exclude the use of changes in exchange rates as an instrument of adjustment, particularly for a reserve currency. One can understand, therefore, why they feel that the correction of external deficits is likely to be a prolonged process; it is because they think it inappropriate or not feasible to use policy measures of such kind and strength as would make the correction a more rapid process. The inevitable conclusion they draw from this view of the nature of imbalances in international payments is that there must be ample borrowing facilities available to supplement official reserves, so that countries will be able to finance their deficits in the interval of time required for the longer-term adjustments of the domestic economy to take place.

In answer to this view of the matter, the other side in the debate more or less says: nonsense—all that is just an excuse for not taking effective corrective measures. In their view, deficit countries are generally too cautious in using monetary and fiscal policy to promote the adjustment process and put too high a priority on avoiding disturbance to the domestic economy. The surplus countries, on the other hand, rather than not being under pressure to help in the adjustment, are, they feel, by being subjected to excessive surpluses, left to make most of the adjustment through the internal inflation induced by these surpluses. This side accepts the idea of controls over capital movements in

case of need and, indeed, believes that a deficit caused by the outflow of capital (apart from temporary flights of funds) should not be financed by international assistance. While they are in theory less shocked by the idea that exchange rates may sometimes have to be adjusted, they are naturally reluctant to say when and where this drastic remedy should be applied. The inevitable conclusion which they draw from their view of the matter is that borrowing facilities should have strict limits, because, if the surplus countries continue to finance the deficit countries, there will never be an end to it.

Thus, the two key problems of the system in the official debate are the efficacy of the adjustment process and the adequacy of international liquidity. These questions are matters of judgment rather than of rigid proof, but I believe that the experience of the various countries during the past ten years provides the basis for an objective view. I will take up both of these problems, starting with the adjustment process.

THE ADJUSTMENT PROCESS

By the adjustment process is meant the chain of corrective changes in the domestic economy, and even directly in transactions of the balance of payments, whereby countries in deficit or surplus come back into equilibrium.

Political Obstacles

It is perfectly clear from experience that this adjustment process cannot be left to happen all by itself, simply with the passage of time, but that effective policy measures must be instituted by the authorities to promote adjustment. At the same time, it is equally clear that the main obstacles which get in the way of prompt and effective action, and thereby drag out the adjustment process, are not economic difficulties but political difficulties. In case after case in the postwar period, we have seen deficit countries procrastinate and play around with half-measures while the situation deteriorated, reserves were drawn down, and liquid resources were borrowed from abroad—not because the need for policy action was not clear but because political difficulties stood in the way of firm action. And then, as the means of financing the deficit became scarce and a crisis developed, we have seen such obstacles brushed aside; the policy actions previously claimed to be impossible and unworkable suddenly became possible and did work.

It is not only in the deficit countries that political considerations have interfered with appropriate policy-making. In the surplus countries where there was need to curb excess demand, to take one example,

restraint by fiscal measures has often been sidestepped because of their political unpopularity, while the task of suppressing inflation was left to monetary policy. The result was higher interest rates and an inflow of money from abroad, contributing to the imbalance in international payments.

If further evidence of the importance of political considerations in stabilization policy-making were needed, one would only have to review some of the policy programs put forward by governments in election years.

Can anything be done in our real world to reduce the political hazards to stabilization policy so that the adjustment process will work more promptly and in a shorter time? While there is no possibility, of course, of the authorities being able to take measures, in a political vacuum, as it were, that affect the lives and pocketbooks of a good many citizens, it is feasible, I believe, to improve on past practice—and I am optimistic enough to feel that it is being improved. The main thing is to have a more general comprehension that flexible use of policy instruments is essential in managing the economy so as to maintain not only high employment and expansion but also domestic and external monetary stability. It is not only the government that has to take this need to heart, but also the political opposition and the important interest groups in the general public.

Besides this, it is feasible to improve matters by separating more clearly the technical adaptations of policy measures from the fundamentals of policy that are necessarily political. In many countries this is largely the case in the area of monetary policy, so that such measures as changes in the central bank's discount rate not only do not require Parliamentary approval but arouse little political controversy. In the field of fiscal policy, however, such flexibility is generally not available at present, even though it is quite clear from experience that fiscal measures must play a key role in maintaining monetary stability. It is not too much to say that the whole mechanism of the annual budget, which involves the impossible job of forecasting developments a year to eighteen months in advance, and which largely freezes fiscal policy over that period, is no longer adapted to the flexible role that fiscal changes have to play in the management of the economic climate. This inflexibility could be reduced by delegating to the stabilization authorities circumscribed powers within which they could make technical adjustments to increase or decrease overall demand as the situation might require.

No doubt, however, politics will always be politics, and that means that the advocates of international hard money have a strong case in

saying that there must be limits to liquidity. Reserves and borrowing facilities must be able to run out, because in the end there must be a liquidity pinch to assure that action is taken to restore external balance.

Economic Obstacles

Leaving the political factor aside, let us come to the economic side of the adjustment process and ask whether, in the nature of the case, correcting imbalances must necessarily be either slow or rapid in a contemporary industrial economy. Experience has shown that there are different kinds of situations or cases in this matter.

The relatively simple cases are those in which an external deficit has been directly linked with excessive domestic demand and internal inflation. In such cases there is no dilemma for policy, because measures to restrain excessive internal demand will at the same time act to correct the external deficit. It is evident from the experience of numerous countries that this adjustment can be quite rapid and that in as little as six months after effective measures are taken there can be dramatic improvement in the situation. From an international standpoint, the real difficulty in such cases is in denying borrowing facilities to the country in question until it is prepared to institute an effective program of restraint—for this also is a problem that cannot be free from political considerations.

But, while we can say on the basis of observation that a good many instances of external deficit are of the kind that can be fairly quickly resolved, there have been cases in recent years that, even with prompt and pointed action, would have taken a longish time to overcome. In these more difficult cases policy has been confronted with a clear dilemma, owing to the fact that the external deficit was not obviously linked with excessive internal demand. Hence, the taking of forthright restraining measures to reduce the external deficit would have been against the interest of the domestic economy, which was not in need of demand restraint. Similarly, countries with an external surplus have been confronted with domestic inflationary pressures, so that expansionary policy measures, which would have been helpful in reducing their surpluses, would at the same time have threatened the domestic economy with even more inflation.

In considering policy action for these difficult cases, it must be recognized that in our accepted scale of values the objectives of full employment, economic growth, and price stability do have relative priority, and it is evident that neither deficit nor surplus countries are willing to sacrifice them wholly to the goal of external balance. Indeed, the perplexing aspect of reconciling domestic and external objectives arises

because all countries want to maintain a shock-absorbing cushion around the domestic economy to isolate it in some degree from outside forces. In this type of situation, deficit countries are unwilling to accept all the deflation that might be needed to eliminate the deficit quickly; surplus countries are unwilling to accept all the inflation that might be needed to eliminate the surplus quickly. While one must agree that this position is reasonable, one must also insist that if there is to be any sort of adjustment process, domestic objectives cannot have absolute priority. At times it must be possible to shift the emphasis of policy to favor the correction of an imbalance of payments—even at some sacrifice of the domestic aims.

Current-Account Imbalance

The nature of the adjustment process in these cases depends upon whether the imbalance is concentrated on the current or on the capital transactions of the balance of payments. If it is on the current account, what makes the situation difficult is that the cost and price levels have gotten out of line and thereby, from the standpoint of the deficit country, have weakened the international competitive position of the economy. In such a situation, exports tend to be sluggish and a normal expansion of economic activity induces rising imports and a deterioration of the current external balance. The adjustment process requires that domestic incomes, particularly wages, be held in check for some period of time, during which the normal increase in productivity operates to strengthen the competitive position. A firm wages policy, combined with the avoidance of demand pressure on the labor market, has been effective in a number of cases in securing this kind of adjustment. In other cases, this type of policy has failed to improve the relative competitive position of the deficit country, either because wage restraint was not firmly held or because it was frustrated by demand pressure. The outstanding case, of course, was that involving the United States and western Europe a few years ago, in which the successful outcome depended not only on the maintenance of wage restraint and stable prices in the United States but on some upward movement of prices in the surplus countries of Europe. Between 1958 and 1964 this process resulted in marked improvement of the U.S. trade position and in a large reduction in Europe's current-account surplus.

Thus, experience shows that the adjustment process can work for this type of imbalance and shows also what kind of adjustment policy measures must aim to bring about. It is evident, however, that sufficient adjustment of cost and price levels by these means cannot be accomplished overnight; the process will take time if the deficit to be

overcome is at all significant. It seems to me that the surplus countries would be quite prepared to make allowances for this stickiness in the corrective mechanism. That does not mean, however, that the process should take forever and, indeed, signs of improvement should emerge without unreasonable delay. If the supposed policy action does not produce results, it is generally safe to conclude that there was more exhortation than action. Some attempts at wage policy, for example, remind one of those disarmament agreements of former times which always seemed to end up with an increase in armaments.

Before leaving this matter of imbalance on current account, it may be noted that there are often cases where the disparity between the cost and price levels has become so large that it is rather hopeless to expect wage restraint and rising productivity gradually to restore the international competitive position of domestic enterprises. In such cases, there is nothing for it but to adjust the exchange rate to a realistic level. While changes in exchange rates may be looked upon as the ultimate instrument for assuring the adjustment process, they are definitely part of the mechanism of the international monetary system. I stress the point because more than a third of the less-developed countries today have overvalued exchange rates, which are handicapping their efforts to develop their economies. Of course, if all the instruments of adjustment are to be ruled out, if the price of the currency is to be a matter of prestige, the price of foodstuffs a matter of politics, and the price of labor a matter of monopoly—with some cartel pricing thrown in besides—one will have to wait a long time before seeing anything that could be called an adjustment process.

Capital-Account Imbalance

We may turn now to an imbalance due to excessive flows of capital funds. In this aspect of the adjustment problem experience is less of a guide to an objective appraisal, because the only outstanding case since convertibility was restored at the end of 1958 has been that between the United States and continental Europe. And it is the more difficult to appraise because it has been complicated by the rapid growth of the Euro-dollar market. While there have been other disturbing movements of funds, they have not been an independent cause of imbalance but have been associated with threats to exchange stability from other causes.

In the case before us, the imbalance reflected the fact that in the United States capital funds were fairly plentiful and interest rates relatively low, while in Europe the supply of such funds was more limited compared with demand, and interest rates, therefore, were relatively

high. The differences between the two areas were substantial and persistent enough to be called a structural problem. The classic remedy of a tighter monetary policy in the United States and an easier monetary policy in Europe seemed to be indicated, in order to reduce the differentials in the availability of funds and in interest rates. I may say that, in advocating this line of policy, I for one did not consider that the whole of the U.S. balance-of-payments deficit would thereby be corrected, or even that it should be. But the policy should have been able to make a significant contribution—along with other measures to improve the trade and invisible balance and the balance on government transactions. Some progress was made in this direction up to 1963, as interest rates in Europe tended to decline gradually after 1958 despite booming conditions in 1960-61, and short-term rates were held up in the United States. But, as the United States was reluctant to tighten the monetary situation enough significantly to affect long-term rates for fear of stopping domestic expansion, and as Europe began to shift monetary policy to restraint in 1963 to combat inflation, first Europe and then the United States introduced special techniques to limit excessive capital flows.

In the circumstances, these measures were clearly needed. But one may go further: if there is to be a reasonable margin of freedom to use general monetary policy to restrain or stimulate the domestic economy, the authorities must be able to use special instruments of control over flows of capital funds to help manage the balance of payments—when there is a conflict for monetary policy between domestic and external objectives. One must, however, guard against thinking that this is the end of the matter—thinking, that is, that such controls, which are sanctioned in the Bretton Woods Agreement, can always be relied upon to assure a rapid adjustment process and that other policy measures are not needed. The use of control instruments is a retreat from convertibility which involves dangers of its own. For one thing, controls are not likely to be effective over a long period if they imply too great a suppression of market forces. For another, their continual use is likely to put a growing burden of adjustment on the capital account of the balance of payments, which would not be justified on strictly economic grounds. Hence, it is necessary that the appropriate mixture of monetary and fiscal policy be used to move towards a basic equilibrium of market forces. As with the difficult adjustments in the current account, an adjustment to a true equilibrium of interest rates and capital flows in present circumstances would involve a slow process of adaptation and structural change, unless other objectives were drastically sacrificed.

The conclusion to be drawn from this review of the problem of the adjustment process is that in the real world both kinds of cases of imbalance arise; in some, prompt and effective policy action can produce a quick correction, while in others the difficulties cannot be overcome in the short run. There have been cases of this latter kind over recent years, and for them access to international credit facilities in fairly large amounts was necessary to finance the slower-acting swings. To be sure, by stronger and more prompt action, the swinging could have started earlier and gone faster, and this is the core of the adjustment problem. While the primary responsibility for corrective action will always be on countries in deficit, it is evident that in the difficult cases the surplus countries also have a contribution to make. If you wanted to award gold stars to countries in which domestic political considerations have not stood in the way of full policy action to help the adjustment process, I believe you would not have to give away many gold stars. The action which some other countries ought to take always appears easier than that which each country itself should take. To improve the adjustment process, the pot must stop calling the kettle black and come to a realistic understanding of respective adjustment responsibilities.

While the implication of the existence of difficult cases is that borrowing facilities must be ample to handle rather prolonged adjustments, it must be emphasized that there must be an adjustment process. International liquidity cannot take the place of it, and there is no way of changing or reforming the system so as to avoid this hard reality. This is so, even if continued lax policy would bring matters to what is called a breakdown, which really means a major change in exchange rates. Self-discipline is not enough; liquidity must be able to run out and force corrective measures to be taken. Anything else means that some countries should be able to live on the real resources of other countries forever.

Return to the Gold Standard

Before coming to the problem of international liquidity, I may discuss the possibility of a return to the gold standard, as it is essentially with the aim of making the adjustment process more automatic that this step has been proposed. The criticism of the present system involved here is that under the gold-exchange standard many central banks may let their reserves rise by the accumulation of dollar assets, thereby financing the balance-of-payments deficit of the United States. This process may go on in a rather inconspicuous way until the convertibility of the dollar into gold is threatened, which is also a threat to the

stability of the system. However, the argument runs, if the principal countries were to hold only gold in their reserves, the United States would be faced with a loss of gold as soon as an external deficit appeared and would take firm corrective action more promptly.

This argument has its element of truth. There has been lax use of the gold-exchange standard, which did weaken the position of the dollar and which had inflationary consequences for the surplus countries, although the latter is not unavoidable. Nevertheless, there are several considerations which make the gold standard an unattractive solution of the adjustment problem.

1. Central banks did not take up the practice of keeping dollar assets in their reserves because of any formal agreement but because they found benefits in doing so. If they were to give up the practice, they would also be giving up the benefits. These benefits include the possibility of holding earning assets in reserves, which is important to the independence of many central banks, and that of having access in case of need to a large and flexible international banking center. This flexibility would have to be very much restricted if the United States were threatened with loss of gold for every large foreign borrowing on its market—even if it were not at the time in deficit. It was this flexibility of the gold-exchange standard that enabled European reserves to be re-established in the 1950s, which, in turn, greatly facilitated Europe's rapid reconstruction and economic expansion. With the dollar shortage at that time and the widespread discrimination against dollar goods, the moderate increase in official holdings of dollar assets reflected the initiative of other countries to build up reserves rather than initiative by the United States to finance its deficit. Even in recent years the same kind of process has been operating for the increase in dollar reserves outside the main financial countries, as the increase was the counterpart of borrowing from the United States.

2. Any of the main countries has a potential access to liquidity from its own reserves and from borrowing facilities that enables it to stretch out the adjustment process and have a major impact on its trading partners. This would not be much different if the principal countries held only gold in their reserves, unless credit were drastically curtailed in the system. In the case of the United States, for example, once the main central banks recognized that their holdings of dollars were becoming excessive, they limited the further increase by their own policy. Yet the U.S. deficit continued. Since the end of 1960, increased dollar balances of the European central banks in the Group of Ten have financed less than a billion dollars of the U.S. deficit. The bulk of official financing has been either by gold sales or by open use of credit,

such as the IMF, Roosa bonds, and debt prepayment by foreign countries, with the swings financed through the swap network.

3. Looking more deeply into the question, it is doubtful that there could be a return to the gold standard in a meaningful sense. The various elements of monetary movements in the balance of payments include the net short-term foreign position of the private-banking system, which the central bank can influence in a variety of ways when it finds it in the interest of the country or of the international market situation to do so.

4. Of course, if international credit were eliminated from the system and if domestic liquidity were made to change fairly automatically with changes in gold reserves, the effect of the gold standard would be to give overriding priority to external adjustment over domestic objectives. This would be to give up the real progress that has been made in reconciling policy objectives and it is hard to imagine that either deficit or surplus countries would risk it. Few advocates of the gold standard argue for such automaticity. To attempt to impose such a system on a large scale would be more apt to lead countries away from gold than to make gold the absolute monarch of the system.

INTERNATIONAL LIQUIDITY

I may turn now to the second of the basic problems about which official viewpoints have differed, namely, international liquidity.

Since it was stated in the Group of Ten Report, the conventional thing to say about liquidity has been that it is fully adequate for overall needs at present but that some time in the future it is likely that a shortage would develop. The reason for this is that there is only a limited supply of new gold available for reserve purposes and that dollars could not continue to supplement gold in official reserves to the same extent as in the past without endangering the stability of the system. Thus, the volume of international transactions would tend to outrun the increase in gold and dollars and a shortage of liquidity in the future would ensue.

As to the situation in recent years, the large U.S. deficit has necessarily meant that the increase in gross official reserves in the system has been large. Excluding the United States and the United Kingdom, the increase in the reserves of the industrial countries in the years 1960 to 1965 averaged \$2 billion—which is large, indeed, and was a factor in the inflationary tendency in the surplus countries. With this situation, it was easy enough for all the countries to agree that a better

balance in international payments was the urgent problem and that the trouble was not a shortage of liquidity.

There was, and is, however, a sharp difference of views behind these words. When some countries say that liquidity at present is adequate they mean that there is already enough, and that international credit should be tightened to limit a further increase so that deficit countries will be forced to end the payments imbalance. When other countries say that liquidity is adequate, however, they refer not only to the present size of total reserves but also to the process by which reserves are increased through the use of credit facilities. To them the continued access to credit facilities is the essential element that prevents a shortage of liquidity, because it makes it possible for the swings in payments to be financed.

It will be seen that these views about liquidity stem from the difference in emphasis that the two sides put on the possibilities of speeding up the adjustment process. As I said earlier, this difference of opinion is not about problems of the dim future but about problems of the past few years and, indeed, of the present moment. It is this concern with the present that has stood in the way of any agreement about the future mechanism of reserve creation, although the likelihood of a future problem is accepted.

* * *

Let us now take up this question of international liquidity and try to disentangle the various aspects of it.

In what follows, I wish to differentiate sharply between three kinds of liquidity need: (1) the needs of individual countries in balance-of-payments difficulties; (2) the need of the system as a whole for an adequate aggregate of liquidity; and (3) the need of the system as a whole for an adequate marginal increment to reserve assets. The first two of these are concerned with the adequacy of the means to finance deficits—though in different senses. The third, however, is not directly concerned with the financing of deficits but with the need for a workable equilibrium of the system. To be somewhat paradoxical, one might say that it is concerned with the financing, not of deficits, but of surpluses.

Liquidity Needs of Particular Countries

The needs for liquidity that individual countries may have are to enable them to meet their deficits, or to bolster their reserves so as to give the public confidence in the ability of the authorities to maintain the exchange rate at parity. Such needs must not be confused with a possible shortage for the system as a whole. For, no matter how ade-

quate the aggregate reserves of the system might be, some countries might run into balance-of-payments difficulties, either because their domestic policies were too lax or because market conditions had moved against them, and find themselves with insufficient reserves to meet the situation. This is especially so because the reserves of the whole system are never likely to be distributed in a roughly proportionate way among the countries.

There is no disagreement among the countries on the value of official cooperative arrangements to provide borrowing facilities for such individual cases, nor about keeping such arrangements in line with increases in the volume of international transactions. The conception lying behind the use of these facilities is that they are to finance shorter or longer balance-of-payments swings, but that there will be a swing and that the borrowings will be repaid. The IMF is the backbone of this system and the use of its facilities is available to its members on a three-to-five-year basis, provided that the borrowing country shows a reasonable effort in its policies to correct its deficit position. Besides the IMF, liquidity assistance is available through the combined bilateral credits known as Basle arrangements and through the network of swap arrangements of the Federal Reserve System with the other principal central banks and the BIS. Assistance of this type depends solely on the credit standing of the borrower. As I mentioned earlier, many countries also regularly use private-banking facilities to help in financing temporary swings in their external position.

I will pass over the question of the adequacy of borrowing facilities for such individual country needs, except to say that, in my observation, there has always been lots of shorter-term money available for any country willing to make a determined effort to put its situation right.

Liquidity Need of the System

Thus, the liquidity problem that is at issue is the requirement of the system as a whole, and it is to this problem that the Group of Ten Report is referring when it speaks of a possible shortage of reserve assets in the future.

There are two aspects to this problem and it is largely because they have not been clearly isolated that there has been much confusion on the matter. The aspect on which attention has focused is the aggregate mass of official reserves or of reserves plus borrowing facilities. In considering whether there is, or is likely to be, a shortage of this global mass for the needs of the system, one must be clear about the function that this liquidity performs. It is not used day in and day out directly to finance the inflows and outflows of trade and other current and cap-

ital transactions of the balance of payments; these are expressed in national currencies and financed by the banking systems of the various countries. Reserves are called upon only to finance any differences that arise between the mass of the inflows and outflows settled on the exchange market and which the private market itself does not carry. The authorities have to use reserves to finance these net balances that remain, for otherwise the forces of supply and demand would tend to push the rate of exchange outside the support points.

In this backstopping function to the private financial system, it would be possible at times for the global mass of liquidity to be too small for the role it has to play. Such a situation in an acute form existed on a regional basis in western Europe, even after the realignment of exchange rates in 1949. The countries had had their reserves depleted by the war, and exchange stability was being maintained only with the help of a mass of quantitative restrictions on imports and exchange controls. Although they wanted to get rid of these restrictions and move back to convertibility, each country was afraid to do so because it did not know how its balance-of-payments position would be affected and whether its reserves could stand any temporary strain that might be put upon them. The brilliant arrangement hit upon to overcome this global shortage was the European Payments Union. In effect, the Union more than doubled the available reserves for the settlement of imbalances within the group of countries by providing automatic credit of 60 per cent for any multilateral deficits among them. This assurance on the side of payments was a necessary condition at the time for the adoption of the Code of Liberalization on the side of trade.

One may agree that there is not at present a shortage of global reserves or liquidity in this sense. However, with a limited amount of new gold available for increasing reserves and with the increase to reserves from holdings of dollar foreign exchange likely to be at a much smaller rate, the global mass of reserves would tend to grow much less than previously in relation to the expected rise in the volume of international transactions. By this arithmetic process, if it worked out that way, a time would come when a shortage of total reserves would develop.

However, a future difficulty of this kind does not seem particularly urgent for several reasons. First, the amount of total reserves that could be considered adequate relative to the volume of international transactions cannot be stated with any kind of precision and it may be that the present total is much more than enough. (This point may be exaggerated, however, if account is not taken of the fact that reserves should be enough not only to finance reasonably normal swings in the balance of payments but to do so without dipping so far into the reserves as to

raise fears in the market that the exchange rate is threatened.) Secondly, the adequacy of global reserves is necessarily a rather vague concept and much will depend not only on the arithmetic progression mentioned above but on how it works out in practice. For example, if a few countries with rather large dollar holdings were at the present time to lose dollars to the United States, total reserves in the system would be decreased. But rather than create a difficulty, a reasonable fall of this kind would strengthen the system. Thirdly, if reserves were adequate to start with, it would take a considerable time for a significant shortage to develop, because the ratio between reserves and transactions would be only marginally reduced by the changes in any one year. With respect to this aspect of the problem, therefore, no acute difficulty seems to be in the offing and complaints about the process of reserve creation being haphazard have little force.

The Normal Increment to Reserves

The other aspect of the problem of the reserve needs of the system concerns the operational norm for the annual increment to reserves. This aspect of the matter is more immediate. Countries generally would like to stay on the right side of equilibrium, and, in order to do so, their normal aim is to have a moderate annual increase in reserves. This aim is not only appropriate from the standpoint of the individual countries themselves, but perfectly appropriate for the system as a whole—since it is desirable that a shortage of aggregate reserves in the system should not develop. However, if the available increment for reserves is not sufficient, this normal aim is bound to be frustrated for some countries in the system. This is not a theoretical question, but a practical one.

To see what is meant here, one must consider the existing available sources for increments to reserves. In the system at present, new gold output (or dishoarding) is the only asset that can provide increments to reserves without some country or other being in deficit. This is because gold is a current-account export for the gold-producing countries at the same time that it is a reserve asset for the surplus countries. Any other increase in reserve assets, whether direct holding of foreign currencies (mostly dollars) or borrowing from the IMF, must reflect credit transactions in the sense that they involve liabilities for some countries corresponding to the increases in reserve assets of other countries. These liabilities really are deficit items for the countries concerned and, indeed, the only reason why the statistics of global reserves rise as a consequence of such transactions is that the reserves are counted gross instead of net of the liabilities.

But, at the same time, while all countries generally want to see their

reserves rise moderately, no country is expected to pile up liquid liabilities continuously and no country can be pleased to be in deficit for an extended time when it means accumulating short or medium-term debts which hang over its head. Our conception of the norm for the system may be defined, therefore, as a situation in which the sum of all countries' surpluses (increments to reserves) is equal to the annual net flow into reserves of gold or a limited amount of other assets which are not a fixed-term charge on the reserves of the deficit countries. While we would not expect this norm to be attained at all times, the available increment to reserves should make it feasible for the system to attain it, if all countries were following reasonably good policies. The fact of the matter is, however, that this norm is not operational.

The flow of gold into reserves from 1960 to 1965 averaged about \$600 million a year, and even without unusual private hoarding it would not be much larger. It is hard to envisage that, for any period of time, the sum of the surpluses of the Group of Ten—let alone of all convertible-currency countries that happened to be in surplus—could normally be limited to such an amount of new gold alone, even with the deficit countries pursuing active policies of adjustment. Stabilization policies for a sizable group of countries cannot be expected to secure such precise results—given the huge volume to which aggregate international transactions have grown. To the extent that it did not, the difference would necessarily show up as deficits of other countries. One might say that deficits in the countries that at the time happen to form the weakest links in the chain (leaving aside the persistent debtors among the less-developed countries) are not an aberration of the system but just about a norm of the system. In effect, the countries are playing a game of musical chairs in aiming to stay out of deficit; but when the music stops there are almost certain to be some unable to find seats. This is not because the system is inherently defective, but because the technical instruments for providing an adequate increment to reserves in a sound way have not kept up with the legitimate needs for such instruments. It has been noted that the annual increase in reserves of the industrial countries, excluding the United States and the United Kingdom, averaged \$2 billion in the years 1960 to 1965. While we have seen that this amount was excessive and contributed to inflation, particularly as the reserve-currency countries did not get an appropriate share of it, it is a far cry from the \$600 million of gold that was available. The conclusion to be drawn from this situation, with new gold for reserves so tightly limited, is that a sound and acceptable supplement to gold should be designed and fed into the system in amounts that provide a sensible annual increment to reserves.

What has made it difficult to recognize and isolate this need is that in practice the problem presents itself mixed up with the need to improve the adjustment process. For, when you examine the "weakest links in the chain" where the deficits are occurring at a particular time, you always find some whose deficits are unreasonably large because they are not taking effective steps to correct their situations. For this reason, I wish to repeat what I said earlier about the necessity for improving the adjustment process. I emphasize, also, that the supplement to gold that is needed is not of a size to cover up all the laxity in which countries may choose to indulge. On the contrary, it should be limited enough so that countries will have to walk a fairly narrow path, in managing their affairs, to earn some share of new reserves. But with the increment now available, they have to walk a tightrope. To see this, it is only necessary to think of how many countries would have to share the \$600 million of gold, and how little each would have to be limited to, for there to be equilibrium in the system. There is no point in having an ideal norm for the system that is impossible to attain; we need a norm that, with good behavior, is operational. Indeed, without it there is some difficulty in telling to what extent behavior is not good.

The reader may wonder why this problem should have arisen now, whereas it did not seem to cause difficulties in the past. Without going back too far in history, we may take note of some important changes that have occurred. After the price of gold was raised in 1934, the annual increment of gold to official reserves up to the outbreak of the war averaged \$1.7 billion a year—about three times what it has been lately. The money value of all international transactions, on the other hand, was in 1937 only about 15 per cent of what it is today. In contrast, the volume of gold coming on the market, after a sharp decline during the war, has only in the past few years regained its prewar peak. This has been due almost entirely to the discovery of new rich gold fields in South Africa, which started to produce on a significant scale in 1953. At the same time, the private use of gold—even apart from speculative buying—has multiplied enormously. By the standards we have today, therefore, the increment to reserves was not only ample, but excessive, in those prewar years.

We can pass over the first five years after the war as a time of monetary readjustment. In the period from 1950 to 1957 the problem did not come to light either. The main reason for this was that, with the great strength of the dollar, supported by massive gold reserves, the United States could supply a sound and desirable supplement to the increment of gold in the form of dollars. And it was high financial statesmanship that made this happen and also allowed some redistribution of the U.S.

gold stock. The outflow from the United States of gold and dollars to other countries' reserves during those years averaged around one billion dollars, of which a quarter was gold and three-quarters were dollars.

In addition, there was the European Payments Union, which, as I mentioned earlier, played an important role in supplementing the reserves of western Europe. Even so, I am not sure that the situation would have remained sound through all of this period if the new South African gold fields had not come into substantial production, and I am positive that without this new production governments would have had to take up the liquidity problem of the system much earlier than they did. By 1958 these new fields already accounted for \$350 million of the gold coming to market and in 1965 they accounted for about \$850 million. These figures represent more than half of the gold increment to reserves in 1958 and much more than all of it in 1965.

With the sudden shift in the U.S. payments position from a surplus in 1957 to a persistently large deficit (and the demise of the EPU at the same time), it was not long before the situation was drastically changed. The eruption of the gold price in October 1960 may be taken as marking that change. Continued increases of dollar holdings in reserves could no longer be looked upon as an appropriate way for reserves to increase, because they began to be a threat to the external stability of the dollar, and the United States itself struggled to find the policy measures for ending its deficit. Hence, the problem of an adequate and sound increment to reserves was already with us four or five years ago. It did not come clearly to the surface at that time, however, because priority had to be given to the absolute necessity for the United States to face up to using policy measures to manage its balance-of-payments situation effectively. Without this, a fruitful negotiation on the liquidity issue was not possible.

Thus, the prospect of a balance in the U.S. payments position has made the problem of the increment to reserves of immediate concern. It will be seen that this does not mean that there has been, or will be in the near future, a shortage of aggregate liquidity for the system as a whole but that appropriate means for the increment to reserves will be lacking. It has been said that a shortage of liquidity for the system would show itself in the future by a struggle for reserves among the countries that would lead to a general deflationary tendency in the world. While one could work out a model on these lines, I doubt that the behavior of countries will develop in this way. From the inflationary climate we have been having, my imagination is too limited to visualize governments outdoing each other with deflationary policies—and I do not think they would stay in office long if they tried it. What seems to

me more likely, with a deficient increment for reserves, is that some countries will be in deficit, that there will be threatened or actual exchange instability, that restrictions in payments will be resorted to, and that the standards for the use of official borrowing facilities will deteriorate. But these are not troubles for some dim future—they are troubles that we have already been living with.

I shall refrain from discussing here the various alternatives for assuring an appropriate increment to reserves, as this might be done by a combination of facilities and, in any case, could only be settled by negotiation. It seems to me, however, that the solution should give a prominent place to a facility of the type, say, of EPU quota credits, or composite-reserve units (as their inventor, Mr. E. M. Bernstein, has called them), or perhaps a multilateral Roosa bond network. This facility would have to have agreed limits determined by the needs of the system and would have to be restricted to countries whose balance of payments could be expected to fluctuate around equilibrium in the longer term. The feature of this type of credit facility is, of course, that it is specified or understood that any drawings on the facilities need not be repaid within a fixed time but can be left for the shifts in balance-of-payments positions as they occur. I cite these examples to distinguish them from borrowing facilities having relatively fixed dates for repayment, such as normal IMF drawings or central-bank swaps, and not to suggest that they could not be set up in the IMF framework. It puzzles me somewhat that some authorities express this need as being one for "owned reserves" rather than for "borrowing facilities," as I consider that all reserves must be "owned" and that any reserves other than gold must arise out of credit transactions, that is, by use of "borrowing facilities." The point is rather the terms and conditions that attach to the facility. It was never thought in EPU days that outstanding balances were anything but credits, but the liabilities were not a near-term charge on the reserves of the debtor countries. Perhaps what is involved here is merely a difference in the use of language.

In any case, it seems to me that if there were a suitable and sufficient supplement to gold such as this, then it would be clear that deficits which arose were a departure from an attainable norm. This should have two good effects: it should contribute to improving the adjustment process, and it should facilitate the application of higher standards for use of other borrowing facilities. I believe firmly that this was what happened in the practical operation of the EPU.

* * *

In conclusion, I have tried to show that there are two essential and

distinct problems to be faced in the international monetary system—improving the adjustment process and designing an appropriate supplement to gold for the normal increment to reserves. These are the problems of today and I believe that they should be dealt with together, because one reacts on the other. To deal with them fruitfully, it seems to me that certain aims and principles should be recognized in the interests of assuring a sound system. I will list them without any particular order.

1. The IMF is the central body for providing assistance to countries falling into balance-of-payments difficulties, as all agree, and its resources must be kept adequate to do the job as the world economy grows. While supplying resources to the IMF is an act of cooperation, it should be made reasonably attractive to countries doing the cooperating and the creditor positions they hold in the IMF should be remunerated accordingly—as are other nongold holdings in reserves.

2. Central-bank facilities have proved their great convenience and should be extended to make the handling of temporary market shifts more flexible.

3. Facilities should be designed to provide a supplement to gold for an adequate and sound financing of normal increments to reserves. The size of such facilities should not depend on the size of deficits but on an appraisal of what a practical equilibrium of the system could be. The reserve assets arising from the use of these facilities should also be instruments worth holding.

4. Access to conditional borrowing facilities should be on strict standards, implying a program for correcting the deficit which looks forward to restoring balance and to repayment of the borrowing.

5. There should be no confusion between assistance for the purpose of liquidity needs and that for investment needs.

6. A realistic exchange rate should be a prerequisite for access to borrowing facilities, for otherwise there is no end to liquidity needs. A realistic rate should imply at the very least no restrictions on imports of basic materials.

7. Even with a reasonable supplement to gold, the policies of central banks with respect to the composition of reserves will have to be based on the fact that the new gold available is limited and that all countries together cannot get more than there is.

While I believe that these ideas can be a guide to improving the international monetary system, let me say finally that there is no such thing as a perfectly logical system or a definite end to financial problems.

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