

ESSAYS IN INTERNATIONAL FINANCE

No. 57, January 1967

A DOLLAR-RESERVE SYSTEM AS A
TRANSITIONAL SOLUTION

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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FRITZ MACHLUP, *Director*

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A DOLLAR-RESERVE SYSTEM AS A TRANSITIONAL SOLUTION

The deadlock in the debate on international monetary reform reflects apparently irreconcilable positions on several planes, some of them overlapping: whether there is, or will soon be, too much or too little international liquidity (however defined); whether the gold-exchange (or reserve-currency) system is basically a satisfactory arrangement or is highly dangerous and in urgent need of replacement; whether such replacement ought to take the form of a system based on gold—rigorously, à la Rueff, or at least anchored to it—or a system based on international credit creation; whether international credit creation would be multi-national or supranational, and in either case, which countries would participate in, and decide on, credit creation, and how.

This list does not purport to exhaust the issues on which there is vociferous disagreement. Rather it brings into relief those conflicts on which it seems that a decision will have to be taken one way or the other, leaving out theoretical alternatives which, for practical reasons, stand little chance of implementation.

It is the purpose of this paper to suggest that on the real bread-and-butter issues the opposing positions are not as irreconcilable as they seem, and that a solution can be devised which allows each party to hang on to its pet idea, while at the same time permitting gradual progress towards a saner international system to which no party can rationally object. (With one proviso—the proposal would not in itself solve the problems of chronic exchange shortage of the underdeveloped countries, in the manner, for example, of the various Stamp Plans.)

There is, of course, an element of arbitrariness in deciding which are the “real” or “practical” controversies to which the discussion should be narrowed down. It might be as well, therefore, to set out the underlying assumptions, both with regard to alternatives to be dismissed as unrealistic, at least in this decade, and with regard to the direction in which the international monetary system is likely to evolve in the long run.

The Alternatives

To begin with the latter, a plausible case can be made that international money is passing through the same stages as national moneys, with a lag of anywhere from 50 to 150 years. Domestically, money

evolved from being full-bodied, through representative and fiduciary, to book-entry money. (I have avoided the more commonly used term "deposit money" for three reasons: to keep clearly in sight that even today most "deposit money" is the result of credit creation rather than of cash deposited; that with increasing computerization even the "deposits" of individuals will increasingly result from the direct transfer of incomes to the individual's bank account, without any actual deposit of cash, checks, or other tangible credit instruments; and to allow for overdrafts, as already employed in the banking practice of other countries.)

Internationally, the gold-exchange standard represents the counterpart of representative money. What today's controversy is really about is (1) whether an attempt should be made, through appropriate adjustments, to make this present system of international representative money serve longer, either by restoring confidence in the key currencies (and possibly increasing the metallic base through a rise in the price of gold) or by enlarging it into a multiple-currency-reserve system; or (2) whether we might move on to the fiduciary stage, either gradually or by cutting the umbilical cord with gold once for all, making the dollar, probably also sterling, and perhaps eventually one or two other moneys true international reserve currencies, independently of any gold convertibility; or (3) whether we could jump straight over the fiduciary stage and establish international credit money.

Two further alternatives, it will be noted, have been left out. (1) Going back to a pure international gold standard: assuming, for the sake of argument, that such an animal ever existed after the rise of industrialism and international specialization, this would be such a retrograde step that it is hard to credit that even many Frenchmen can be serious about it. And (2) flexible exchange rates: for all the recent academic interest, they are plainly unacceptable to central bankers and men of affairs. Whatever the merits of flexible rates, they will therefore not be considered as a presently practical alternative—and here the element of arbitrariness admittedly creeps in.

We are thus left with the three practical possibilities enumerated above. And this is the time to spell out the second underlying assumption. Few of us can doubt that the world at large, like national entities before it, is moving towards a system based largely on credits and debits in the books of banks. But it is the writer's contention that the world is not yet ready for it. Something like Keynes' Clearing Union or the Triffin Plan is not only the most rational solution, it will also, in time, be seen as such by everybody (well, almost everybody) and be adopted. But two factors militate against its early adoption: "*natura non facit saltum*," and bankers and the general public do so even less.

Yet, after all, bankers must operate the system, and the money must be acceptable to the public. Moreover, there is another objection: for all the ingenious safeguards devised by Triffin (for example, that open-market operations of the XIMF be undertaken only with the consent of the governments concerned, and that the annual increase in credit might be agreed upon *a priori*), it cannot be denied that national governments would have to abdicate at least part of their monetary sovereignty; and this simply is not in the cards before the nations are ready to give up at least part of their political sovereignty. If today the countries of the EEC are not even close to adopting a common monetary policy, let alone a common currency and central bank, how can one seriously expect that a super-central bank will be acceptable to a hundred-odd sovereign countries?

The Evolution of International Money

The world needs an international currency. If the time is not yet ripe for "bancor" or some similar internationally created unit, then either gold or one or more national currencies must, for the time being, serve this purpose. The case against gold, either in the guise of a pure international gold standard or as a fixed fractional reserve against outstanding liabilities, is overwhelming: Either the minimum-reserve ratio would have to be set so low as to be entirely unsatisfactory to the Continental gold enthusiasts, or the price of gold would have to be raised recurrently—and the obvious undesirable consequences of such a procedure are too well known to require elaboration. Equally well understood today is the fact that the so-called international gold standard of the 19th century was for practical purposes a sterling standard. To be sure, sterling was convertible into gold; but while the Bank of England's fiduciary note issue was rigorously limited, there certainly was no mechanistic limitation of "sterling liabilities to foreigners" to any fixed multiple of the Bank's gold reserves. Fortunately, perhaps, neither the Bank nor the Board of Trade had shown enough ingenuity to develop our modern, sophisticated liquidity concept, and thus Continental bankers could sleep peacefully.

For twelve years after World War II, the world was unambiguously on a dollar standard; the gold convertibility of the dollar was incidental and irrelevant. Only since 1958 have we had this hullabaloo about a dollar crisis, and the plethora of admonitions that we "restore equilibrium," that the further creation of reserve assets in the form of increased dollar balances is unacceptable and must be stopped as soon as possible, and that, if necessary, additional international reserve assets must be based on the inclusion of French francs, Deutschmarks,

and other hard currencies (in addition, perhaps, to larger IMF quotas and drawing rights).

To seek refuge in a multiple-currency-reserve system (while simultaneously halting the further accumulation of dollar and sterling balances) may seem an attractive solution. But it has at least two serious shortcomings. For one thing, either the choice of key currencies to be held as foreign-exchange reserves is left to each country's central bank, in which case, as Professor Machlup has remarked, we seem to have forgotten the painful experiences with bimetallism and the more recent periodic rushes of short-term capital in and out of gold, dollars, and sterling, and are prepared to compound the trouble by adding a few more permutations; or the distribution as among reserve currencies is rigidly fixed, in which case we are back to the endless bickering whether there is too much or too little liquidity, who shall determine periodic increases in reserve assets, and how. Moreover, there is an equally strong second objection to such a "solution." Sterling in the 19th century, and the dollar in the 20th, did not become key currencies by accident, or arbitrarily. To use a convenient terminology, they came to be widely accepted as "reserve currencies" because they had established themselves as international "vehicle currencies"; not only were the United Kingdom and the United States principal trading nations, but even trade among third countries was financed through London and New York, and so were capital transactions.

Little has changed in that situation, except that New York and London have reversed positions. The large majority of commercial transactions are still financed in dollars and sterling, and the narrowness of capital markets other than New York and London is notorious. In these circumstances, to elevate, say, the French franc by fiat to the status of a reserve currency, solely on the ground that France has managed to keep its currency "hard" for fully eight years, is so artificial as to be ludicrous. Nor is there any indication that the Germans or the Swiss are anxious to see their currencies used more widely outside their borders, and thus outside their control.

Similar considerations militate against relying on reserve creation through the IMF as an adequate solution. Two schemes of this kind (not necessarily mutually exclusive) are being canvassed: the extension of quasi-automatic drawing rights of the gold-tranche type, and the issuance of reserve units by a Fund affiliate, membership in which would be open to all Fund members.

Additional drawing rights could be provided within the existing framework of the Fund's Articles of Agreement. This institutional continuity would be a great advantage, both because it should make it easier to implement the scheme, and because familiarity with the concept of

drawing rights as well as experience gained in the Fund over the past 20 years should ensure smooth operation. As a broadening of the Fund's role the scheme deserves wholehearted support. Yet it would not be much more than restoring the *status quo ante*: the totally unforeseen rate of growth in world trade has increasingly hampered the Fund in fully playing the part originally envisaged for it; by granting additional drawing rights the Fund would simply catch up with the volume of trade that needs to be financed—even if it is agreed that the Fund's resources need not be related to the absolute volume of trade, but only to the amplitude of fluctuations in it.

In principle, of course, drawing rights could be increased to any amount considered desirable by the most expansion-minded members. But experience in connection both with the last increase in quotas and with the negotiations leading up to the General Arrangements to Borrow must convince even a determined optimist that whatever agreement can be hammered out is more likely to err on the side of caution and conservatism than otherwise. Nor should it be forgotten that even at the outset of the Fund's operations, when its resources seemed much more adequate than today to cope with normal balance-of-payments fluctuations (once reconstruction had been accomplished), the existence of the Fund did not dispense with the need for using the two key currencies. Nothing that has happened since suggests that even greatly increased drawing rights could be a *substitute* for rather than a *supplement* to other forms of international liquidity (also in increasing amounts). As will be argued below, central bankers do not seem prepared to consider drawing rights—lines of credit—a satisfactory substitute for owned reserves.

The second scheme—creation of Fund reserve units—raises difficulties of a somewhat different sort. In the first place, these reserve units would be issued not by the Fund itself (where foot-dragging by the more conservative-minded members would effectively stymie creation of anything like an adequate amount) but by an affiliate of the Fund. This surely is a step in the right direction, if the scheme is to get off the ground at all. It also means, though, that Fund members that do not participate in the scheme might be unwilling to accept Fund units in payment of debts. As long as one or more surplus countries refused to participate, little would be changed from the present situation where they are reluctant to hold dollars. In fact, however, additional complications would arise. Transfers of Fund units would (to quote from the IMF's 1966 *Annual Report*) "be subject to an element of guidance" in order to avoid "the necessity for countries in balance-of-payments difficulty having to accept transfers from other countries and [to bring about] a general proportionality between holdings of the new reserves

and other forms of reserves." In plain English, there are three jokers in the deck: it is openly recognized that at least some countries would not treat Fund units as fully interchangeable with other reserves; prior agreement has to be reached concerning the proper proportions in which Fund units and other reserves are to be either held, or accepted in payment of debts—and it appears at least doubtful whether such agreement would be easier to reach than agreement about the mode of implementing the Posthuma Plan or any other multiple-currency-reserve plan; and by submitting to the "guidance" of the Fund affiliate, central banks would be deprived of the freedom to distribute their reserves according to their respective preferences as among presumed safety, presumed liquidity, and earning power. (Should, for example, Japan be compelled to hold a larger proportion of its reserves in gold than at present, in order to conform to the compromise proportion?)

Finally, another doubt creeps in. The existence of an international gold-exchange system dates from the discussions at the Genoa Conference of 1922. What persuaded so many countries to add sterling and dollars to their gold reserves was the wide use of sterling and dollars as international trading currencies. The proposed new Fund units, on the other hand, are specifically to be held and used by monetary authorities only. This sharp separation of the reserve-currency and vehicle-currency aspects of international money constitutes a much sharper break with the past than, say, a revaluation of gold or further extension of the key-currency system. This is not to suggest that such a separation of functions is impossible; but the break in continuity should certainly be taken into account, not only in considering the probable reaction of bankers and traders but also in thinking through the implications for monetary policy. In any event, though, the need is not alone for increasing official reserves but also for increasing private cash balances of some kind of international money. Even if early agreement could be reached on the creation of official reserves—and it is a big "if"—the writer must admit to considerable doubt whether such Fund units (as currently envisaged) could ever become a fully satisfactory substitute for gold or key currencies.

No, on this count Roosa is right: the obvious solution lies in adapting and evolving the present system (to paraphrase Lord Butler's delicious barb, it is after all the best system we have), at least until a new generation of bankers and a better-educated public are ready for a system of centralized reserves and/or international credit creation. For the foreseeable future, the dollar will not only have to remain the primary reserve currency of the free world but any need for increases in inter-

national reserve assets, over and above newly mined gold, will have to take the form of increased foreign dollar balances.

European Objections

And what about the opposition to this idea from the Continental Europeans? Do we not first have to balance our international accounts and restore faith in our currency by overcoming the "dollar crisis"? The "dollar crisis" is a sham and a delusion. We have allowed ourselves to become the victims of misinterpretation by Europeans of our balance-of-payments presentation. What this presentation obscured (quite apart from the asymmetry in the treatment of private short-term credit) is that, as Messrs. Despres, Kindleberger and Salant have argued so convincingly in the *Economist* (of February 5, 1966), the United States has become the world's financial intermediary, borrowing short and lending long. As the most cursory glance at the balance of international indebtedness of the United States will show, this country's overall financial position vis-à-vis the rest of the world, far from weakening, has been growing stronger year by year. Add to this that, through all the years since the so-called dollar crisis was first proclaimed, the dollar's purchasing power has remained relatively more stable than that of any other currency, and it becomes easy to understand why not only nonofficial foreign dollar balances have continued to grow—certainly from choice, not as a result of U.S. Government "persuasion"—but also why a number of countries—Canada, Japan, Sweden, for example—have elected to hold on to large dollar reserves, apparently more impressed by facts and figures than by the hue and cry raised in some Continental places. And, unless we manage our economic and financial affairs less well than we have in the past five years, there is little reason to believe that non-European governments as well as international traders and private banks will in future be any less willing to hold interest-earning dollar assets. On the contrary, as long as world trade expands, and as long as a large proportion of it is financed with dollars, the needs of foreign traders and bankers for dollar balances will grow.

This leaves certain European governments and central banks that might be unwilling to accumulate any further dollar balances, and might even wish to convert part or all of their existing ones. But this need hardly be a problem for the United States, even today. Total liabilities to Western European official institutions (including U.S. Government marketable securities of more than one year original maturity, though excluding nonmarketable U.S. Treasury notes and bonds) have long been hovering around \$7 billion. Of the countries that have shown an inclination to convert a large part into gold, only Italy, West Germany, and Switzerland (with total balances—official *and private*—of between

\$1.5 billion and \$2 billion each) and France (with \$1 billion) are of any importance. Of the other countries of the new "gold bloc," Belgium holds only approximately \$350 million, and the Netherlands approximately \$300 million in dollar balances—official *and private*. It follows that the United States could easily satisfy the demands of all of them, even if they chose to convert their entire official dollar balances into gold. In fact, the United States might well encourage them to convert to their hearts' delight, thereby removing a perennial cause for complaint and clearing the decks for a new initiative. (To reassure the remaining dollar holders, however, explicit guarantees—exchange guarantees or foreign-denominated bonds—may have to be offered. We shall discuss this later on.)

Establishing A Dollar-Reserve System

This new initiative would look to the firm establishment of the dollar as the chief international reserve currency, on a voluntary basis, that is, for all countries that wish to be included in the system. The first opportunity to do so and thereby rid the world's monetary system of the shackles of gold (as had already been done for national monetary systems in the 1930's) was missed in the years 1945-1957—partly from lack of foresight and imagination, and perhaps partly also because the public in the United States was still too strongly wedded to the gold link. We have learnt our lesson, but we may temporarily have lost the initiative. After seven years on the defensive psychologically, the moment may not be propitious for the necessary steps to be initiated—even though the "weakness" of the dollar is apparent rather than real. But under no circumstances must we let the next opportunity slip by. It seems reasonable to assume that with fixed exchange rates there will continue to be alternating periods of "strength" and "weakness" (on a liquidity basis) for the dollar, as there have recently been for the Deutschmark, for the lira, and for the guilder. (Nor can France expect to escape the ebbs and flows in international payments. The history of the French franc between 1926 and 1938 ought to serve as an awful reminder to France's money managers, who at the moment seem to be riding the crest of the wave just as cockily as they were in 1931.)

In the United States we seem to be stuck, for the time being, with the liquidity concept of the balance of payments, the Bernstein Report notwithstanding. To be satisfied with a zero deficit on the "basic balance" or the "official-settlements balance" might too easily appear as fiddling, and therefore might not be a solid enough basis from which to launch the transition to an international dollar-reserve standard. American policy-making should therefore be two-pronged: for the short term, measures to overcome the balance-of-payments deficit on *any* definition,

specifically including the liquidity concept; but, equally important, plans must be formulated *now* for the long term, to be ready for implementation when the tide turns again.

Much has been said and written about the immediate problem of restoring the liquidity balance; there is no need to add to it here. What needs discussing is the preparation of a longer-term policy which, introduced at a favorable juncture, would prevent a repetition of the alarms and excursions since 1958 and finally bring us, on the international plane, the liberation from the gold fetish which for the domestic money system was achieved everywhere more than 30 years ago. It should quickly be added that this argument is not meant to suggest that we can in future disregard our international accounts; quite the contrary. With the United States having taken over the Bank of England's former role as the world's central banker (until the willingness of nations to abdicate part of their sovereignty makes it possible to establish a truly supranational monetary system), it becomes all the more important that our financial and economic policies be conducted with the highest sense of responsibility. But, just as nobody can reasonably contend that the devaluation and practical (domestic) demonetization of gold in 1933-1934 led the Federal Reserve into a loose and irresponsible policy over the past 30 years, why should anybody expect that the international demonetization of gold would tempt our financial and economic managers into an orgy of irresponsibility? Given the caliber of the men concerned, plus the fact that we understand today a lot more about economics and finance than we did 30 years ago, there is indeed every reason to believe that we shall remain highly sensitive to the international repercussions of domestic policies, and shall use our painfully acquired economic knowledge in full awareness of our intertwined national and international responsibilities, to the benefit of all countries associated with us in the new dollar-reserve system. In the immediately foreseeable future (after the demonetization of gold), that would mean maintaining balance in international payments on an "official-settlements" or similar basis (though not any longer on a liquidity basis) by pursuing appropriate policies to keep our payments in line with our receipts. In the longer run, as we move ever more into a "mature creditor" position, it may even involve liberalizing import trade (perhaps unilaterally vis-à-vis less developed countries) to prevent the emergence of a persistent payments surplus.

The Nature of a Dollar-Reserve System

What such a new world financial system centered around the dollar (perhaps jointly with sterling) as international reserve (as well as "vehicle") currency would look like is not too difficult to visualize.

A model is provided by the role of sterling in the 19th-century international financial system, with free convertibility at fixed exchange rates and freedom of capital movements as well as absence of exchange control on any other transactions. Only minor modifications are called for:

1. We would be concerned not with gold convertibility but with free convertibility between national currencies and the international reserve currency (or currencies). International gold convertibility in the 19th century was the logical counterpart of each country's domestic gold standard. Today, after more than 30 years of domestic fiat moneys, our clinging to international gold convertibility (directly or indirectly, *via* the dollar) is an anachronism—and 30 years should be more than enough to outgrow a cultural lag.

2. We may not be able to revert to permanently fixed exchange rates; instead, we may have to retain the nebulous criterion of "fundamental disequilibrium" and allow for today's greater price and wage rigidities by continuing with a system of "adjustable pegs" for the non-reserve-currency countries. It goes without saying that this option cannot be open to the reserve-currency country (or countries). To make what in effect is a system of (American-created) international fiat money work, a quite special responsibility devolves upon this country's money managers: the value of the dollar must be kept as stable as possible, at the very least no less stable than that of any other currency.

3. It may be necessary to acknowledge the right of non-reserve-currency countries to impose exchange control in specified circumstances. For industrialized countries this should be looked upon only as a last resort—when a sudden and dramatic loss of reserves leads to a speculative run, and the psychological effects of devaluation might in the short term be destabilizing rather than stabilizing. Except for such emergencies, however, developed countries should resort to devaluation, if necessary, and not to exchange control—certainly not to exchange control on current account. For developing countries, however, the situation may be more difficult. Not only does their chronic shortage of foreign-exchange reserves make them more vulnerable to fluctuations, but inelasticity of demand for their few staple exports (and possibly also the difficulty of curtailing essential imports) may counsel against exclusive reliance on exchange-rate adjustments.

Once again, the right to impose exchange control, at least on current account, cannot be claimed by the United States, without destroying the system. Since the United States alone can overcome a short-term emergency by creating more dollars, there would be no justification whatever for resorting to (current-account) exchange control. To prevent a protracted deficit (though *not* measured on the present

liquidity basis) by market-conforming policies is a *conditio sine qua non* for the reserve-currency country.

The case is less clear-cut when it comes to the control of capital movements. Nonetheless, there is much to be said in favor of preserving the tradition whereby the United States, unlike many other countries, does not avail itself of the right (under the IMF Agreement) to control capital movements. America's importance as supplier of international investment capital will, if anything, grow; and, with the formal establishment of this country as the creator of international reserves, its ancillary role—to refer once more to the Despres-Kindleberger-Salant argument—as international financial intermediary will come to be much more widely understood. We should therefore take care to present the interest-equalization tax and the “voluntary controls” on capital outflow as strictly temporary expedients and not allow them to become—legally or psychologically—entrenched.

4. Finally—and this is not so much a departure from the earlier British model as an adjustment in our own thinking—the United States must (when the time comes) unequivocally accept the implications of being a responsible creditor country. When New York began to rival London as an international financial center, the integrated world economy of the 19th century broke down—partly because it proved difficult to run two international financial centers in tandem, partly owing to the repercussions of World War I, but in part also because the United States was not prepared to accept the responsibilities of an international financial center, specifically the willingness to allow the trade balance to adjust to the capital balance. The interrelation of domestic economic and financial policy with international trade and finance has become clear to the most isolationist observer since we started losing gold and dollars. Have all of us learnt that this lesson applies to a surplus as much as to a deficit?

The Transition

So much for an outline of a future dollar-reserve system. The transition to this new system, when the moment is judged opportune, would be accomplished by taking the following five measures:

1. All reluctant official holders of dollar balances are invited to convert them into gold, at the present parity, thus giving any country the choice of opting out of the new system to be introduced.

2. Treasuries and central banks that are willing to continue holding dollar balances must be reassured that their interests will in no circumstances be sacrificed. Such reassurance is needed specifically during the transition period, not only on account of the system's novelty but also because paying off those countries that have opted out will have brought

a sharp drop in our gold stock, and this must needs induce some nervousness among the remaining dollar holders. The U.S. Treasury has in the past rejected any suggestion that it give a gold or exchange guarantee; and it can be argued that if the dollar needs crutches of this sort it can hardly become the medium of a new fiduciary system. Moreover, since the new system will presumably be introduced at a time when the dollar is once again *seen to be* strong, there will in any case be none of the nervousness and suspicion of the years since 1958. Once again the dollar will seem intrinsically superior to gold, as in the years after 1945 when the acceptability of gold rested on its convertibility into dollars rather than the other way round.

All this is no doubt true as regards the successful operation of the system, once it has become established. Yet it may be urged that the initial stage, when everybody has to get accustomed to unfamiliar ideas, needs all the help it can get. And, since the entire new arrangement has to be based on the clear understanding that the international reserve currency—the dollar—cannot be devalued vis-à-vis other currencies (though the value of national currencies may be readjusted vis-à-vis the dollar), to give foreign dollar holders an explicit exchange guarantee at the originally prevailing rates (adjusted for any subsequent devaluation of national currencies *but not for any upward revaluation*) would be psychologically helpful without sacrificing anything of substance.

Three objections can be raised against taking such a step: first, an open-ended exchange guarantee might be construed as a gold clause in another guise, and thus be of dubious constitutionality; second, it might lead to large-scale shifts from foreign private to foreign official holdings; third, unless the guarantee were extended to all domestic holders as well, it would discriminate against United States residents in favor of foreigners.

The first two objections (if they are judged to be sufficiently serious) can be met by offering foreign official holders not a flat open-end exchange guarantee but the option to convert dollar balances into non-marketable U.S. Treasury bonds, either exchange-guaranteed or denominated in the currency of the foreign holder. This option would apply to all foreign official balances, including those resulting from shifts out of foreign private into foreign official balances. While the sums involved might be considerable, nonetheless this would no more than extend the principle of the Roosa bonds; and it would still be for finite amounts.

This may seem an awesome commitment to undertake. But it needs to be stressed once more that the scheme could in any event not be launched until international confidence in the dollar has been fully re-

stored. Any anxiety that might then lead foreign authorities to take up the option would not stem from a general atmosphere of crisis—as it would now—but from the novelty of the proposed arrangement and the need to adjust to it gradually. As the new system plays itself in, the extra security afforded by special U.S. Treasury bonds will be progressively outweighed by higher earnings obtainable from other forms of short-term dollar investments. And this largely transitional nature of the measure (as well as the finite amounts involved, instead of an across-the-board guarantee) also serves as a counterargument to the objection that United States residents would be discriminated against. Moreover, as long as we steer clear of exchange control, residents always have a similar option to invest their funds in foreign currencies.

3. The Congress would be asked to abolish the economically functionless requirement of a 25 per cent gold backing against Federal Reserve note liabilities. Not only would it be logical at this juncture to tidy up our domestic currency system; this step would also free our gold reserves explicitly (instead of making them available in emergencies, as under present statute) and thus gain the necessary room for maneuver.

4. After satisfying all gold demands from foreign official holders, the U.S. Government might then elect to dispose of part of its remaining gold stock, perhaps by first offering it for sale to countries with convertible currencies desirous of adding to their gold hoards, against their own exchange-guaranteed interest-bearing government obligations. (At, say, 5 per cent, this might add a welcome \$300 million to \$400 million per annum to our balance of payments. There is no reason why we should not shift as much as possible of the opportunity cost of burying the useless stuff to the new gold addicts. At the same time these interest-bearing obligations would serve, vis-à-vis countries that insist on balances being settled “in cash,” as foreign-exchange reserves on an *ad hoc* basis—without the complications of formally establishing a multiple-currency-reserve system.)

Quite possibly the International Monetary Fund might wish not only to re-acquire the gold it sold to the United States under repurchase agreements, but also to acquire additional amounts. Whether this would happen as part of an agreed special increase in the quota of the United States (as the now formally established reserve center of the new dollar area) or as a directly negotiated transaction between the Fund and the United States, will depend upon at least two factors: to what extent the Fund has in the meantime increased its lending capacity and liberalized its rules for extending credit, and how many IMF member countries will ultimately join the new dollar area.

Perhaps it is worth stressing once more that the establishment of a

dollar-reserve system is to be looked upon only as a (longish) interim arrangement, until a truly supranational XIMF or IRI can be set up. Great care must therefore be taken to avoid anything that might lead to the weakening, let alone the dismantlement, of the IMF. If there were any hope of an early agreement on transforming the IMF into a true supranational credit-creating institution—which would imply handing over to it part of every nation's economic sovereignty and, to quote Professor Machlup, abandoning the "cloakroom rule of international reserves"—it would be hard to justify the creation of a dollar-reserve system. As it is, we must at least recognize such a supranational central bank as our ultimate goal and do nothing that might prejudice the gradual transformation of the IMF.

5. The final step would be the suspension of the Presidential Proclamation of 1934, under which the Treasury buys and sells gold in international transactions at \$35 per ounce. In terms of the IMF Agreement, the United States would declare that it would henceforth operate under Article IV, Sections 3 and 4, rather than under Article IV, Section 2.

Professor Haberler, among others, has suggested that a mere hint by the United States that it would not indefinitely be committed to buying gold at \$35 per ounce might stop any rush to convert dollars, and might even lead to large-scale dishoarding of gold. If that were to prove correct even in present circumstances, it would apply *a fortiori* to the time for which the new departure is contemplated, that is, when the (liquidity) balance of payments of the United States has swung back into surplus. Such a reflux of gold would no doubt reassure any skeptics abroad that our financial position was "sound" after all; but we would unfortunately be stuck with the mystic metal that much longer. Perhaps there is a compensating advantage in that, too: the transition to an international fiduciary money could be so smooth and gradual as to be almost imperceptible. The United States went off the gold standard domestically in 1933—but not quite. A statutory—but in practice meaningless—"gold backing" against Federal Reserve liabilities was retained, at which we have been nibbling away ever since. Whatever arguments could be marshalled in favor of this domestic demonetization of gold by stealth might apply internationally as well. When the world has got used to the new state of affairs, the stockpile of gold, or at least part of it, could be declared surplus and sold through the London gold market. It could also, after rescinding the legal prohibition of 1933, be offered to members of Professor Spahr's "Economists' National Committee on Monetary Policy" and other like-minded citizens who have never forgiven or forgotten the crime of '33. And, as the *Economist* suggested nearly six years ago, when it "prematurely"

published excerpts from Per Jacobsson's (fictitious) "memoirs" ten years before they were written, in the end we might always be able to sell the gold to dentists at \$2.50 per ounce.

Summary of the Case for a Dollar-Reserve System

The present international monetary system, based on the IMF and on dollars and sterling as key currencies (but with only the dollar freely convertible into gold) needs—at the very least—shoring up. Of the several charges levelled against it, two are indisputable: that since 1958 dollars have in some instances been held only reluctantly; and that any "restoration of confidence" in the key currencies, presumably by means of reversing the deficit of the key-currency countries, would automatically bring in its train severe international deflation. In discussing ways of solving this dilemma, our energies should be concentrated on achieving the one solution that is both logical and (for the next decade) alone practicable: the formal switch from the gold-exchange system to a reserve-currency system, that is, the progression, internationally, from representative money to fiduciary money. A number of alternative solutions are theoretically possible, but might as well be ruled out from discussion because they are politically unacceptable ("return" to a pure gold standard, increases in the price of gold), or in practice unacceptable to bankers and traders (flexible exchange rates), or unworkable (multiple-currency-reserve system), or, finally, premature (transformation of the IMF into a credit-creating super-central bank).

The argument was largely presented in terms of the U.S. dollar as the logical reserve currency. Two observations are called for: First, the reasonable and equitable long-term solution is still a truly international (or, rather, supranational) central bank; but until the world is ready for it, some interim solution, possibly lasting a few decades, must be found—and a dollar-reserve system seems in practice the only candidate.

It may be objected that an interim solution could be found along a different route: a vigorous expansion of the IMF's lending facilities. But this only brings us back to the old, and apparently insurmountable, obstacle that member countries simply cannot agree on the need for additional liquidity. Even if member countries that worry about inflation, not deflation, could be brought to accept some contingency plan for increased IMF credits, such acceptance would be reluctant at best. In practice, this would inevitably mean some compromise plan hedged around with so many "safeguards" that any action that the Fund could take in a crisis would be too little and too late. Such a "solution" surely must be totally unsatisfactory to the United States, Great Britain, many other industrial nations, and above all to the developing

countries. Nor is this the only difficulty: even if IMF credit facilities were liberalized to the satisfaction of a majority of the member countries, it is unlikely that central banks and national treasuries would look upon lines of credit (even if unconditional—which they probably would not be) as an adequate substitute for owned reserves. Nonetheless, any progress in liberalizing IMF credit should be welcomed as a stepping stone towards the ultimate goal; and a dollar-reserve system must be regarded as a temporary supplement to an evolving IMF, not a substitute for a truly supranational system.

Second, an international fiduciary system may still be based on the two key currencies of the gold-exchange system of the past (depending on how rapidly and successfully the United Kingdom overcomes its difficulties), and possibly even on cooperation with one or two more countries. But this is by no means the same as advocating a multiple-currency-reserve system as currently understood. Not only can there be no question of including ten or twenty currencies, but it would have to be based on much closer monetary integration between the two, three, or four countries than now exists.

Conclusion

It was claimed at the outset of this paper that the opposing positions in the controversy over international monetary reform are not irreconcilable, and that a solution can be devised which satisfies all parties and yet permits progress towards a safer system. The proposed solution would probably lead to the temporary division of the free world into two currency areas. Such a division is unfortunate but, it would seem, unavoidable. The only alternative is continued stalemate (no matter how ingeniously papered over), carrying with it the risk of collapse at any time. There is no hiding the fact that we are confronted with a fundamental disagreement concerning the role of money in the international economy—a re-play of the old controversy over the gold standard. To expect that the two sides can hammer out their differences and arrive at a universal monetary system representing a synthesis of the two opposing principles is as unrealistic as it would have been—35 years ago—to hope that the believers in money with intrinsic value and the advocates of managed (fiduciary) money could find common ground. One of the two conflicting principles must in the end win out; and there is no doubt in the minds of most of us which one it will be, especially when it is remembered that today's advocates of the old orthodoxy in the international field have long since become Keynesians at home. But, until they are ready to accept the Keynes of the Clearing Union as well, all talk of compromise and synthesis is futile; there can only, in the meantime, be coexistence.

Whether the new reserve-currency system is formally based on dollars alone or on both dollars and sterling, there can be no doubt that it will in practice involve close cooperation between New York and London. The new system would thus in effect constitute, in the first instance, a fusion of the old dollar and sterling areas. Some countries might opt out; others, no doubt, will join in. Perhaps it is not too fanciful to envisage as the outcome a unified reserve-currency area embracing the United States, Canada, Japan, the United Kingdom, most Commonwealth countries, the other EFTA countries, and most of the developing countries. While at the outset the reserve currency would be centrally managed, the other member countries soon would become ever more closely associated with its management, until in time a formalized international system with joint responsibility for credit creation might emerge. Since all participating countries are agreed on the principle of managed international money, such cooperation is perfectly possible—as it is not among the Ten, as long as there are two sides subscribing to conflicting principles.

Side by side with this new reserve-currency area there would exist, at least for a time, a rival group of gold-bloc countries. This certainly need not imply exchange controls between the two areas, any more than the development of common markets and free-trade areas implies autarky. And, just as regional economic groups can be looked upon as way stations to free multilateral trade, so can two currency areas be looked upon as stages on the way to a universal financial system under supranational credit management.

Let me repeat once more: this argument does not deal with present balance-of-payments difficulties. That is a separate problem. Even today it is, in the writer's opinion, apparent rather than real; but as long as the eyes of the men in Zurich, Basle, and Paris are glued to our liquidity position, we have in any case little choice but to achieve a payments surplus on a liquidity basis, by whatever means are necessary—as long as these means do not include permanent protectionist devices which would come to haunt us once the Vietnam war is over and our international competitive position in trade as well as increasing returns from foreign investments help swing us back into surplus. That is the moment for which we must be fully prepared, both because this will *eo ipso* mean a contraction of international reserves, and because the United States (and the United States alone) will have it within its power to reform the system.

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