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MONETARY SYSTEM:
AN ORDERLY REFORM

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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GOLD AND THE INTERNATIONAL MONETARY SYSTEM: AN ORDERLY REFORM

Controversy concerning the role of gold in the international monetary system has persisted for more than a century. Indeed, 1967 marked more than the centennial of Canada's nationhood. It also commemorated the one-hundredth anniversary of the first worldwide conference on the role of gold in the international monetary system. That first conference opened in Paris in June 1867. It was called by Emperor Louis Napoleon for the purpose of reaching international agreement on the adoption of the gold monetary unit of France as the international standard.

Professor Schumpeter considered the proposals put before the conference by the French as the boldest ever made for a worldwide monetary union. However, at subsequent conferences held in 1878, 1881, and 1892, according to Professor Schumpeter, it was because of pressures brought by the United States that discussion was diverted to bimetallism, and the French initiative defeated. Now the wheel has turned, and it might seem that General de Gaulle is getting divine retribution.

Those who have been following the course of current international monetary developments might find it interesting to consult Henry B. Russell's book entitled *International Monetary Conferences*. Though this book was published in 1898, in many respects it remains dateless. For example, the author comments that the United States, at these nineteenth-century monetary conferences, had reverted to "the old pastime of importuning Europe." He also cites a floor speech delivered on April 1, 1874, by Senator John P. Jones of Nevada:

Does this Congress mean now to leave entirely out of view and discard forever a standard of value? Did any country ever accumulate wealth and achieve greatness or attain a high civilization without such a standard? And what but gold can be that standard? What other thing on earth possesses the requisite qualities? Gold is the articulation of commerce. It is the most potent agent of civilization. It is gold that has lifted the nations from barbarism. So exact a measure is it of human effort, that when it is exclusively used as a money it teaches the very habit of honesty. It neither deals in nor tolerates false pretense. It cannot lie. It keeps its promises to rich and poor alike. (P. 153.)

The fact that the Senator's speech was made on April Fool's Day is, I think, a pure coincidence.

Times have changed in one hundred years, but not completely. The French still pledge allegiance to the gold standard. The United States, on the other hand, no longer advocates bimetallism. Its interest in silver has waned. Americans still like the idea of a dual international monetary standard, however; this time it would be based on gold and "paper gold."

We may ask why, after a hundred years of international monetary conferences, men still have not resolved their differences. The answer lies in one word—*power*. That is what one hundred years of international monetary conferences have been about. The 22nd annual meeting of the International Monetary Fund held at Rio, where a new facility for creating international liquidity was recommended, is no exception to this general rule.

There is, however, one important exception to this rule—the United Nations Monetary and Financial Conference that took place at Bretton Woods, New Hampshire, near the end of World War II. The nations that participated at the Bretton Woods conference were not primarily seeking to arrogate national preeminence or glory. A spirit of cooperation between wartime allies prevailed at Bretton Woods. Delegates of 44 nations attended the conference to reach agreement on the charters of the International Monetary Fund and the World Bank. These instruments were developed from preliminary documents, prepared primarily by British and American experts, which did not commit their respective governments to the schemes. The final *Joint Statement By Experts on the Establishment of an International Monetary Fund* (April 21, 1944), which formed the basis for the conference, represented a compromise of earlier proposals. The extent of public controversy attending the development of the *Joint Statement*, in the form of semi-official and public discussions, articles, and pamphlets, was unmatched in the development of any other area of postwar planning. The spirit of the conference was strongly influenced by a common ideal—to facilitate postwar reconstruction, international trade, and world economic development. Indeed, the aspirations that led to the Bretton Woods agreements were uniquely noble and idealistic, rather than narrow or nationalistic. It is doubtful if such a unity of purpose ever before or since has characterized the conduct of international monetary negotiations.

The spirit behind the four monetary conferences that France initiated during the nineteenth century resembled the current situation in international monetary affairs. The purely technical objective of these earlier conferences was to standardize world currencies with respect to their value and content: then each national currency could move more freely,

promoting higher levels of world trade and commerce. But the major participating nations had their own notions about the kind of monetary standard the world needed most. According to Louis Napoleon, for example, all national currencies should have a gold content equal to, or an even multiple of, that of the French franc. This would enhance French prestige and avoid a disadvantage in foreign trade with respect to countries then on a silver standard—mainly the East. It would also avoid the humiliation of having to revise the French monetary unit to suit that of some other currency, particularly the pound sterling. The motives of other major countries were not dissimilar from those of the French. Thus, the ostensible purpose of these conferences, namely, a technical improvement of the international monetary system, turned out to be secondary to matters of national prestige and power politics. While any world monetary conference cannot avoid considerations involving national power and prestige, when these become uppermost in the minds of the negotiators, agreement on a system that can achieve major world objectives is hardly possible. Accordingly, the nineteenth-century monetary conferences failed.

At the present time the 107 member nations of the International Monetary Fund are again considering reform of the international monetary system. A new special facility for creating international liquidity, Special Drawing Rights (SDR's), would be formally established through amendment of the IMF Articles of Agreement. An agreed outline of the proposed SDR facility was developed during a long series of closed official and semi-official meetings between the major industrial countries. The negotiations frequently were hamstrung because of major political disagreements between the United States and the continental European countries—primarily France. The vigorous open debate and spirit of wartime collaboration between nations united in a common cause—which led to the Bretton Woods Agreements—stand in marked contrast to the guarded circumstances under which the SDR arrangement was developed and negotiated.

If the world were an Eden in which all countries agreed on matters of importance, there would be no balance-of-payments difficulty. Imbalances of payments between nations—which accountants could measure and define—would remain. But with agreement on the policies that gave them birth, there would be no payments *problem*. The real world, of course, is not an Eden, and there will be disagreements between nations. The wider the disagreement, the more important the question of *power*. For then power alone may determine whose objectives are to be attained and whose are to fail. Accordingly, this essay will introduce a concept of *international monetary power* to be used in its further analysis.

We shall examine two major elements of the present international monetary arrangement: the reserve-currency system, and the gold-exchange standard. Following this is an exposition of the mechanism for liquidity creation and balance-of-payments adjustment originally designed and negotiated at Bretton Woods. The fact is that the International Monetary Fund currently functions *not* in accordance with the system originally designed at Bretton Woods, but rather in accordance with a series of *policies* subsequently adopted by the Fund—beginning with its first annual meeting (1946) at Savannah. The present-day IMF is very different from the institution that had been envisaged at Bretton Woods. Indeed, implementation of the grand design at Bretton Woods has never even been attempted.

Tracing through the effects of Fund policy decisions helps set the stage for a comparative analysis of the proposed SDR facility. *It is the author's view that the SDR facility should be rejected.* It is not so much a problem of technical design; more importantly, the power structure is unacceptable. In addition, if the IMF Articles are amended to incorporate this new facility, any future effort to achieve a truly viable international monetary system will be seriously handicapped.

An alternative course of action involving, in part, the implementation of the originally designed Bretton Woods mechanism will be proposed. This system remains authorized by the IMF Articles of Agreement. It would *not* require legislative action by Congress, or by other governments, to put it into effect. There will also be recommendations dealing with the voting-power arrangement of the Fund, and further modification of the two-tier gold-price arrangement announced March 17, 1968. Adoption of recommendations of this essay would be linked to simultaneous announcement of the phased dismantlement of all balance-of-payments controls and restrictions adopted since 1959—the year “Buy American” was first attached to the foreign-aid program of the United States.

We have lost the excitement of the times when the United States and the United Nations were striving for better days to come—after victory over the Nazi evil. That spirit is expressed by some of Keynes' words when moving the adoption of the Final Act on the last day of the Bretton Woods Conference, July 22, 1944 (cited in Harrod's *Life of Keynes*, pp. 582-583):

We, the Delegates of this Conference, Mr. President, have been trying to accomplish something very difficult to accomplish. We have not been trying, each one to please himself, and to find the solution most acceptable in our own particular situation. . . . It has been our task to find a common measure, a common standard, a common rule

applicable to each and not irksome to any. . . . And I make bold to say, Mr. President . . . we have been successful. . . . But it is only a beginning. We have to go from here as missionaries, inspired by zeal and faith. We have sold all this to ourselves. But the world at large still needs to be persuaded.

The Concept of International Monetary Power

All modern currencies that circulate within the territories of countries are essentially fiat monies, that is, money established by governmental decree. Sovereign governments also exercise control over the issuance of their national money supplies. However, their *legal* monetary sovereignty does not extend beyond their borders.

A full-fledged international money would require the existence of a supra-national issuing authority. Such money would imply an overriding legal-tender commitment granted by national governments as to its unlimited acceptability for discharging public and private debts within their territories. In this world of sovereign nation-states, a universally accepted international money does not exist: no money circulates freely within and without all national jurisdictions. There are, however, international near-money assets—financial assets which central banks, by tradition and agreement, can use to meet their external monetary and financial obligations. Gold is a form of international near-money asset. A reserve currency is an example of such a near-money asset when used outside its country of issuance. (When the phrase “international money” is used hereafter, this will be short for “international near-money assets.”)

The concept of *international monetary power* relates to who holds international monetary assets, and to who controls their form and issuance. These are two distinct, but closely related, considerations. The first relates to the power of a country to purchase more goods and services from other countries than it sells to them during a specified period. It therefore concerns *international purchasing power*—a country’s ability to finance international payments deficits. Accordingly, this aspect of a country’s international monetary power relates to its stock of international monetary assets, and includes its quick claims to such assets.

The second consideration involved in a country’s international monetary power relates to its ability to *influence and control the form and issuance of international money*. No country, however important, can influence the international money supply to the same degree that it controls its own national money. To some extent all countries influence what shall be regarded as international money by what they actually accept from other countries in financial settlement. They also wield international monetary power in international forums, such as the International Monetary Fund.

International purchasing power is transferred when money is passed. The power to control the issuance of international money, however, is more difficult to acquire. The broad foundation of such power derives from a combination of factors. Some of the most important are a country's economic, political, and military strength, as well as the skill of its leaders to marshal these forces effectively. The size of a country's international reserves can also be a source of such strength. It is the combination of all such factors, whether actively or passively applied, which is at the root of the power structure of the international monetary system, that is, the resulting ability of countries to pursue policies that may lead to payments deficits of their own, as well as to influence or control the availability of balance-of-payments financing to other countries.

The IMF Articles of Agreement allocate international monetary power to countries in accordance with the size of the stocks of their monetary gold, convertible (reserve) currencies, and quotas in the Monetary Fund. The United States, holding the largest gold stock and IMF quota of any country, has enormous power to finance its own balance-of-payments deficits. The fact that other countries accept dollars in international settlement and hold them as reserves confers further international monetary power on the United States. Let us now examine this aspect of American power more closely.

The Hypothetical Case of a Pure Reserve-Currency System

A pure reserve-currency system would be a hypothetical arrangement under which there is no need for gold as an international monetary medium and reserve asset—the reserve currency alone would serve in this capacity. Under such an arrangement the reserve-currency country holds no international monetary assets; it simply creates international money (increases its liquid liabilities) to finance external transactions. Balance-of-payments deficits of the reserve-currency country would then be the source of international monetary reserves in the system, and its balance-of-payments surpluses would contract international reserves. (In the real world there may be need for other forms of international monetary asset for financing transactions with countries not participants in the reserve-currency system.)

The concept of a payments deficit or surplus, as normally applied to nonreserve-currency countries, would not fit the situation of a pure reserve-currency country. Nonreserve-currency countries finance payments imbalances with international money balances which, of course, are limited. A pure reserve center's position, however, is analogous to that of a central bank in a closed economy. Its financing involves the issue of monetary liabilities: there is no drawdown of monetary reserves. There

is, however, a limit on the international monetary power of such a reserve-currency country. It is determined by the necessity that its political and economic policies be in general accord with those of the other members of the system. Otherwise, the system might not continue to exist. To maintain the system's stability, therefore, the reserve center may have to forego important policy options—such as adoption of internal full-employment policies, under some circumstances.

Within this constraint, the reserve-currency country can adopt virtually any program to achieve chosen policy objectives, domestic or foreign, without regard to the balance of payments. In effect, the pure reserve-currency country does not incur balance-of-payments deficits or surpluses. There are, instead, increases and decreases of the international money supply. Accountants can, of course, measure balance-of-payments deficits and surpluses for the reserve-currency country, but these, in themselves, have no meaning: they do not suggest the limit on the extent to which the world may desire to increase its holdings of international money. The real limit on deficits of reserve-currency countries is determined by attitude, that is, whether the measured change of reserve-currency balances is desired or not. Indeed, outstanding reserve-currency balances may not change, while the attitude toward them does change. And since different countries can hold different opinions, depending on their individual circumstances, it is hardly to be expected that a uniform view of the matter would generally exist.

In the context of an international monetary arrangement between sovereign governments, every country holds the power to refuse to grant credit to another country for whatever cause, economic or political. This, of course, is one aspect of a country's national sovereignty. However, if the country to be refused the credit is the reserve center itself, a country wanting to refuse to extend this credit would need to eliminate its external payments surplus. Since under a pure reserve-currency system one country's surplus is another's deficit, the question arises how this should be done. From the viewpoint of the world as a whole, it would be inappropriate for the reserve center to eliminate its balance-of-payments deficit—simply to suit the desires of a particular country that did not want to acquire more reserve currency—as this would involve an arbitrary reduction in the growth of the world's money supply. Indeed, even eliminating the reserve center's deficit would not alone ensure the desired result, as the effects could be offset by the balances of payments of third countries. The most efficient and least disruptive alternative would be for the disgruntled country itself to assume the principal responsibility for the adoption of policies to restore its external balance. Failing complete success, the country could at least convert its "excess" international-money balances into other forms of international asset.

The cost of getting along without international money might be too great under almost any circumstances for some countries. However, for sufficiently rich and powerful countries, there is a likelihood that other arrangements, say, bilateral credits, could be obtained as a substitute for international money. Also, the more powerful the country, the less serious would it regard the economic consequences. The principle of the matter is, simply, that as countries grow more prosperous, they can be increasingly independent. In a world of prospering nations, the effectiveness of any international monetary arrangement increasingly depends on the *voluntary* cooperation of all the participating countries.

The fact that the reserve currency would be involved in the payments and reserve positions of all other countries leaves the reserve center vulnerable to misdirected charges of responsibility for international monetary disturbances. For example, even if its record of internal price and economic stability were unsurpassed in the world, there could still be circumstances in which second and third countries incurred large imbalances of payments between them, with one side unloading substantial reserve-currency balances, accumulated from the past, on the other. The fact that these flows consisted of claims denominated in the reserve currency could create the impression that the reserve center was, somehow, responsible. Indeed, in the real world, the picture would undoubtedly be mixed. If the monetary authorities of the rest of the world desired increases in their international-money balances, they might achieve this objective by adopting more stringent monetary policies (provided, of course, that the effects were not neutralized by countervailing action of the reserve center). Thus, by maintaining on average a somewhat higher level of interest rates (or a less efficient capital market), there could be a continuing net rise in external balances of reserve currency. Under these circumstances, it would not be possible to sort out the direct involvement of the reserve center with respect to the change of any particular country's reserve situation.

The fact that the reserve-currency country receives "automatic" financing for its external requirements has been held as analogous to a situation in which a private firm could operate on unlimited overdrafts. However, in view of the policy constraints imposed on the reserve center—even under the hypothesis of a pure reserve-currency system (so as to allow for maximum benefits to the reserve center)—the analogy to a private firm operating on overdrafts is unacceptable and misleading. The question is, who receives the "privilege" that the "overdraft privilege" extends? A private firm operating on overdrafts receives such credits only at its own initiative, whereas the reserve center must accept such capital whether it wants it or not. There is no reason to suppose that the reserve center would always desire such capital. Indeed, it is not as if

it were likely to be a poor country with a compelling need for such capital. On the contrary, a reserve center is likely to have a relative abundance of capital, and generally prefer to be a net exporter of capital to the rest of the world. Yet the reserve center implicitly imports this capital, regardless of its preferences, whenever external reserve-currency balances increase. The reserve center pays interest charges on this capital, and, as mentioned previously, it foregoes important policy options to perform the reserve-currency function. The advantages to the reserve center must therefore be balanced against important disadvantages. In the final analysis, the net gain or loss of a country from the *pure* reserve-currency system would appear to depend on one's biases, rather than on any clear advantage to either side.

The Existing Dual Monetary Standard

The existing international monetary arrangement can be characterized as a type of mixed international monetary standard. It combines a reserve-currency system, based on the dollar, with the gold standard. The international monetary-power structure accordingly reflects not only the power of the United States to incur payments deficits as the principal reserve center, and the international monetary power of those who hold dollars, but also the power of those who hold gold. In addition, the fact that the dollar is freely convertible into gold on demand of foreign monetary authorities means that the international monetary power of the United States, like that of those who hold dollars, partly depends on the adequacy of its reserves—the gold stock of the U.S. Treasury.

When the current international monetary arrangements were negotiated at Bretton Woods, the United States held most of the world's monetary gold stock; indeed, the value of its gold far exceeded that of dollar balances held externally. Under those circumstances, the rigid convertibility link between gold and the dollar could not affect the international monetary role of the dollar: the world seemed to be on a pure dollar-reserve standard. The United States could, and did, adopt programs to achieve major domestic and international policy objectives without concern about the balance-of-payments consequences. Its gold holdings, although very large, had nothing to do with this situation: the world would have accepted dollars even if the U.S. Treasury's gold stock had not existed.

Over the last decade, however, this situation has changed. There is less political unity in the world. This would create problems regardless of the particular type of monetary arrangement in effect. But today's monetary disturbances are made potentially more serious under the dual international monetary system, because external dollar balances have gradually grown to exceed U.S. Treasury holdings of a steadily deplet-

ing monetary gold stock. The gold convertibility of the dollar is now based only on fractional reserves. The smaller this fraction becomes, the more susceptible is the system to possible collapse. The effect is to reinforce the international monetary power of countries that would threaten the system's collapse: international monetary power has shifted to the reserve hoarders.

The commitment of the United States under the present dual system—to maintain rigid convertibility between the dollar and gold in international settlements—substantially weakens its international monetary power. The United States, as reserve center, must bear the same costs and forego the same policy options as it would under the hypothetically pure reserve-currency arrangement. In addition, however, it is also subjected to the constraints that apply to nonreserve-currency countries: it must eliminate payments deficits as necessary to protect its gold-reserve position. This situation is further compounded by the fact that the private world demand for gold now exceeds the current Free World production of gold at the \$35.00 price. Before the official support of the London gold market was abandoned on March 17, 1968, the gold stock of the U.S. Treasury had been declining as the principal counterpart of the excess private demand for gold. Under the new arrangement, a higher price of gold on the private free market than the official \$35.00 price would generate new pressures for foreign central-bank conversion of dollars into U.S. Treasury gold.

The devaluation of a reserve currency in terms of other currencies extinguishes correspondingly the purchasing power of foreign-held balances of reserve currency. The purchasing power of reserve-currency balances would remain unchanged after devaluation only with respect to the products of the reserve-currency country itself (neglecting possible exogenous price effects, and other currencies that also devalue in terms of gold). For all other products of foreign origin, however, the purchasing power of reserve-currency balances held outside the reserve-currency country would be diminished by devaluation of the reserve currency.

The devaluation of a reserve currency would also cause proportionate write-offs of reserve-currency balances abroad in terms of local (foreign) currency. Such bookkeeping losses could be offset if the country holding the reserve currency were able to devalue its own currency (in terms of gold) in the same proportion as that of the reserve currency; however, such action would not restore the external purchasing power of the reserve currency (for the products of countries that do not devalue). If *all* countries followed suit, the purchasing power of reserve-currency balances, in terms of all other currencies, would wind up precisely where it was before being devalued. Only the purchasing power of the reserve currency for gold would remain reduced in proportion to the devaluation.

Thus, the devaluation of a major reserve currency could create a serious international monetary disturbance if for no other reason than that international liquidity would be extinguished. Obviously countries do not appreciate having their international liquidity destroyed by the action of a foreign country. The effect is that, for all practical purposes, therefore, the reserve center is barred from changing the external value of its currency. This also implies acceptance of continuing constraints on the independence of its economic policies, so as to avoid the possible need of future devaluation, as could be indicated by larger payments deficits (foreign surpluses) than the rest of the world desires. Accordingly, the real cost of the reserve-currency burden might well be high, especially under circumstances in which the maintenance of stability of the international monetary system prevents the adoption of effective full-employment policies.

If, in spite of its responsibilities as reserve center, the United States should attempt to devalue the dollar (in terms of gold), the result would almost certainly be to provoke corresponding devaluations by other countries, with the effect that the devaluation of the dollar, in terms of other currencies, would not stick. The American payments imbalance therefore would still remain. The official price of gold, however, would have been increased, thus creating more liquidity and, hence, international monetary power for countries who hold gold, but none for the dollar holders. The dollar holders would feel cheated. They would blame it on the United States. (Gold producing countries also benefit from a rise in the price of gold; but the benefit is mainly that of an improvement in their terms of trade.)

The existing dual international monetary arrangement provides an option that would not be available to countries under a pure reserve-currency system. Under the existing arrangements, countries can convert dollar balances into gold without reducing their international money balances. Under a pure reserve-currency arrangement, this would not be possible: conversions of reserve currency could not be made into equally liquid international monetary assets. The additional option under the present system permits countries to deny credit to the reserve center without having to reduce their international monetary reserves.

It will be recalled that under the pure reserve-currency arrangement, a disgruntled country could deny credit to the reserve center, but to do so required that it eliminate its payments surplus. Under the existing system, surplus countries can deny credit to the reserve center without removing their surpluses; by hoarding international reserves, they can strengthen their international bargaining positions with respect to the reserve-currency country—that is, their international monetary power is enhanced at the expense of the reserve center. The effect is that

surpluses of foreign countries, and corresponding deficits of the United States, tend to persist. The threat under the existing dual international monetary system of a dollar no longer convertible to gold at *any* fixed official price can never be eliminated as a possibility.

Erosion of Reserve-Currency Status of the Dollar

The complaint has sometimes been heard that European countries object to the proposition that they should willingly accumulate large balances of low-earning liquid dollar claims, so that the United States can invest in high-yielding foreign assets. This is a version of the overdraft analogy in which the United States gets the "privilege." According to this European view, the United States is like the fellow who gets something for nothing, and then complains about the quality of the service.

The well-known Kindleberger-Salant-Despres thesis, that balance-of-payments deficits of the United States are a necessary and beneficial aspect of its acting as a good international financial intermediary, is a challenge to this view. There is undoubtedly merit in this thesis, but its relevance is questionable. The principal bone of European contention, it seems to me, is with the reserve-currency status of the dollar, which allegedly "forces" Europe to provide credits to the United States, and thereby to support American policies and world power. When France converts dollars into gold (from the U.S. Treasury), she effectively rejects the opportunity to participate in the financing of this country's current external deficit, or to refinance such credits as had previously been extended. By requiring the United States to give up gold, France can register a protest against both the status and policies of this country. Furthermore, by adopting policies whenever possible that tend to produce payments surpluses, France can steadily weaken the role of the dollar in the international monetary system. Payments surpluses tend to shift power from the United States to the reserve hoarders, even if dollars are accumulated rather than being immediately converted into gold.

The fact that France may lose earnings by holding gold can be chalked up as an expense of increasing her world power and reducing the influence of the United States. Besides, there is always the possibility that the official price of gold will be increased. The fact that American policy makers may *say* they will not devalue the dollar does not help matters much. There are too many historical precedents where such assertions were made repeatedly by high officials of various governments, only to end up with the currency being devalued.

France is sufficiently strong to act as she does without serious regard to the possible economic costs. The fact that French policies diminish the

opportunity for the United States, as reserve center, to pursue policies to achieve her objectives is the more important consideration. And because the payments deficits of the United States—which correspond to foreign surpluses (except when total international reserves are changing)—can, rightly or wrongly, be cited as the “cause” of instability under the present dual monetary standard, the United States is made to appear as the villain in the piece. Should the official price of gold ultimately be increased, the United States would be held mainly responsible. Those who had hoarded gold would then have “proven” their superior wisdom and foresight. The adverse political consequences to the United States and countries that hold dollars could indeed be formidable.

The failure to achieve international agreement on a *major* reform of the international monetary system reflects the existing political cleavage between the United States and Europe. There is a power struggle in progress to determine which nations shall have international monetary power—the power to incur payments deficits and to control the ability of other countries to incur payments deficits. The result of the struggle will determine the type of objectives that will be facilitated, or checked. If the gold standard prevails, gold holders will gain additional power to achieve their aims. If the reserve-currency system prevails, international monetary power will be conferred to both the reserve-currency country and reserve-currency holder.

A possible compromise might be worked out along the lines of the original system of Bretton Woods, although the existing status of that arrangement is not adequate to the task. This is because there have been technical changes in the structure of the system, since the time of Bretton Woods, that have shifted substantial international monetary power to the surplus countries. These changes were intended to improve the system. In my opinion, the reverse is nearer to the truth. However, by this time, those who have gained power should not be expected to give it up voluntarily. In the case of sovereign governments, national interests are at stake. No government can be expected to yield international monetary power unless convinced that to do otherwise would be contrary to its national interests.

To understand how technical changes in international monetary arrangements since Bretton Woods have unbalanced the power structure of the system, it will first be necessary to review some of the original intentions of the Fund Agreement. We shall then trace the effects of certain important policies and procedures the Fund has adopted since its inception, up to the point of the recent proposals for amending the IMF Articles to introduce a special new facility for creating international liquidity.

Highlights of the Bretton Woods Liquidity Mechanism

Sir Roy Harrod regards the question of the automaticity (conditionality) of drawing rights on the Fund as crucial. Indeed, Harrod suggests that the conditionality of the present system of drawing rights on the Fund is so contrary to what Keynes had expected that “. . . it would have seemed to him that the whole purpose of the I.M.F., on the creation of which he extended so much labour in his last years, would be frustrated.” (*Reforming The World's Money*, p. 121.)

As originally envisaged at Bretton Woods, the Fund was to serve as a source of international reserve supplements that would strengthen the monetary-reserve positions of members almost precisely as if their owned foreign-exchange balances had been increased. To achieve this aim, members were to use their Fund drawing rights almost *pari passu* with the use of their owned foreign-exchange reserves. Members would first draw from their owned reserves. They would then periodically—regularly, say, every month or quarter—draw from the Fund the particular currency *they* specified as needed in an amount equal to about half the amount they had drawn from their owned reserves during the previous month or quarter. Should a member's owned reserves rise in a subsequent period, half of the increase would be transferred to the Fund. The particular (convertible) currencies to be transferred to the Fund would be determined proportionally in accordance with actual changes in the level and composition of the member's owned reserves. Accordingly, except for minor time lags, use of the Fund's resources would closely parallel the use of a member's owned reserves.

The IMF Articles call for drawings of currencies from the Fund to be effected through *purchases* (swaps in exchange for the national currency of the drawing member), not borrowings, and the subsequent reconstitution of Fund resources would be *repurchases* (reverse swaps), not repayments (or amortizations) of debt. This form of transaction reflects the fact that a normal use of Fund resources was *not* to be regarded as in the nature of an international loan, that is, dependent on satisfying conditions of creditworthiness, and to be repaid within a predetermined period of time.

This is not to suggest that Fund resources were to be available freely and without safeguards: there are a number of safeguards in the Articles that apply to the use of Fund resources. There is, however, an important difference of approach between the safeguards of the Articles and those that normally attach to the operations of a traditional lending institution. For example, one of the most important safeguards would derive indirectly from the fact that use of the Fund's resources was to occur only as a member had used its owned reserves. Data available to the

Fund on the international financial assets and liabilities of its members would lessen the possibility that an improper use of the Fund—say, when owned reserves were not declining—would go undetected. The risks of drawings by “uncreditworthy” countries would be limited by two important factors: (a) the size of quotas of poor countries would, in any event, be small relative to total Fund resources; (b) the fact that Fund resources were, in fact, to be available virtually as if they were owned reserves, meant there would be no real cost to the member in restoring its position in the Fund. Transfers of convertible currencies to the Fund (repurchases of the member’s currency) would simply affect the composition, *not* the size, of a member’s total liquid reserves. Certain types of use of Fund resources are also ruled out by the Articles, for example, to finance relief or reconstruction, or to meet large or sustained capital outflows. But there would be no major worry about the necessity of enforcing compliance with such strictures in view of the two factors, (a) and (b), mentioned above. The fact that Fund holdings of currency are gold-value guaranteed by its members is another important safeguard.

The Articles provide for certain exceptions to the mechanism for the repurchase of a member’s currency that are of interest. For example, if a repurchase obligation should arise from an increase in a country’s dollar balances at a time when Fund dollar holdings equalled or exceeded 75 per cent of the United States quota—as at present—then the Articles provide that the repurchase be abated. Also, a repurchase would not be required until the total balance of a member’s owned reserves exceeded its quota in the Fund. (As will later be explained, the Articles also contain safeguards to prevent abatements of repurchases from depleting the Fund of useful currencies.)

The availability of virtually automatic drawing rights against the Fund is limited by the Articles to one-fourth of the member’s quota in the Fund per annum, that is, one “tranche.” A larger drawing could be made in a single year, but only if the Fund agreed to a waiver. A waiver also would be necessary before a member could draw *more* than five successive tranches from the Fund. A waiver of either variety would allow the Fund to examine the member’s policies and external payments situation (in the way that a traditional lending institution would). So long as its drawings did not assume “abnormal” proportions (that is, require a waiver), a member in good standing could continue to have virtually automatic access to Fund resources for the five tranches.

A fundamental understanding of the original Bretton Woods approach is essential to an appreciation of the Fund’s liquidity mechanism. The Fund was intended to create a new form of international money, that is, a highly liquid supplement to owned monetary reserves. Since one

member's payments deficit has a counterpart in another's surplus (except when total reserves are increasing or decreasing), the Fund would take a neutral position: either side's imbalance could be the "cause" of the other's imbalance. Accordingly, Fund resources (drawing rights) would complement members' owned reserves until such time as the *experience* of a protracted use of the Fund might suggest that the member's payments imbalance would not be self-correcting. Only if an imbalance persisted for, say, three or four years, would a consultation with the Fund be required. Such consultations would be triggered automatically by the system of Fund charges. These charges gradually increase in accordance with the duration and number of tranches drawn. Should charges reach the level of 4 per cent per annum, a consultation would then automatically be called for the purpose of considering the cause of the persistent deficit and its appropriate remedy, so that the Fund's holdings of useful resources might not be depleted. Only then would the Fund have the right to interject itself into the internal affairs of a member. Consultations would not necessarily lead to a requirement that the member repurchase its currency from the Fund, or change its basic policies. Indeed, it is not inconceivable that the Fund would determine the member's policies to be generally in order. So long as the Fund were satisfied, the member could continue to draw against the rest of its unused tranches, that is, to the point that Fund holdings of its currency reached 200 per cent of its quota (drawings of five tranches over a five-year period).

Unless the previously described procedure for the parallel use of the Fund and the member's owned reserves is actually implemented, the governing liquidity mechanism of the Articles of Agreement breaks down. To illustrate the point, assume that a member does not use the Fund in the manner described, but, instead, utilizes its owned reserves for a protracted period of years. This reduces the level of its monetary reserves, as reported to the Fund. Now, say, a large drawing of Fund resources by this member occurs. The member's owned-reserve position would be enlarged by the drawing. If the swollen monetary-reserve balance still existed when reported to the Fund (at the end of a financial year), an automatic repurchase obligation would arise to the extent of one half the increase over the balance previously reported. The result would be a "yo-yo" effect, with the member having to return to the Fund resources just obtained from it. Using the Fund in the manner originally intended at Bretton Woods, that is, virtually *pari passu* with the use of the member's owned reserves, would prevent such nonsense results. It is only through the parallel use of Fund resources as a liquid supplement to reserves that drawings from the Fund would not enlarge the reported level of the member's owned reserves, so that the repurchase mechanism

embodied in the Articles of Agreement would work properly and make sense.

As mentioned previously, repurchase obligations might be abated under some circumstances. Nevertheless, the system of increasing Fund charges (and automatic consultation)—in accordance with the level and duration of Fund holdings of a member's currency—would continue to apply.¹

Use of the Fund as the standard operating procedure of *all members*, in accordance with changes in their owned monetary-reserve balances, removes the possibility of there being a stigma attached to drawings on the Fund. Such a system ensures that no more pejorative connotation can be attributed to use of the Fund's resources than can be attributed to the use of owned reserves. The more automatic the procedure for drawings, that is, the more rigid the link between drawings and changes in owned reserves, the more truly Fund resources take on the attributes of international money. An increase in the level of Fund quotas then would constitute a deliberate creation of international reserve supplements.

The Bretton Woods system aimed at providing assurances to Fund members not only that their drawing *rights* would be liquid, but also that, when needed, they would be backed up by an assured availability of useful currencies. Certain safeguards have already been mentioned concerning the appropriate use of Fund resources by its members. There is, however, a further safeguard of great importance: the "scarce-currency" provisions of the Articles. These provisions will be examined below in the section concerning the IMF mechanism for payments adjustment.

Erosion of IMF Liquidity Mechanism

The liquidity-creating mechanism of the Fund, as originally designed at Bretton Woods, is very different from what has actually developed. One of the first important divergences occurred at the first annual meeting of the Fund in 1946 at Savannah, with a decision to make drawing rights on the Fund only conditionally available. The issue of the condi-

¹ A member whose owned reserves had increased, but whose repurchase obligation had been abated, might, under some circumstances, prefer to extinguish this liability. From its point of view, a relevant consideration would be whether the interest earned from retaining, say, (abated) dollar claims as a component of its owned reserves exceeded the interest charged by the Fund. However, if it decided that a repurchase (of its own currency) from the Fund would be desirable, this could be accomplished by conversions of the dollars outside the Fund into some other currency which the Fund could accept (those in which Fund balances were below 75 per cent of quota). Another possibility would be for the member to request conversion of the dollars into gold by the United States. If this led to a decline in the gross reserves of the United States, then the United States would draw back half the amount of the decline, in the currency it needed, from the Fund.

tionality of drawing rights has been the source of some confusion. The fact is that Fund drawing rights were never envisaged as being absolutely automatic—not even by Keynes. Indeed, the system would be unstable if countries could draw from the Fund even when in payments surplus. Thus, drawings were to occur only *on condition* that the member's owned reserves were declining, implying the existence of a balance-of-payments deficit.

The controversy involving automaticity versus conditionality, in fact, concerns a fundamental difference of approach regarding the function of the Fund: shall the Fund provide liquid supplements to members' reserves (as negotiated at Bretton Woods) or shall it serve instead as a more traditional source of international credit—providing finance only when satisfied in advance that the resources will be repaid within a fixed maturity period? Shortly after the Savannah meeting, the Executive Board formally adopted the following policy decision (September 26, 1946): "The Executive Directors of the International Monetary Fund interpret the Articles of Agreement to mean that authority to use resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations." It was also decided informally that countries receiving Marshall Plan assistance from the United States should not be eligible to use the Fund. For all practical purposes, the result was that only the underdeveloped countries could still seek financial assistance from the Fund.

The adoption of this policy approach by the Fund largely reflects American concern that Fund resources would be rapidly dissipated in the devastated conditions of the postwar period. Accordingly, the entitlement of *any* country to draw from the Fund was made subject to *prior* Fund consideration of its circumstances, that is, its likely ability to overcome its payments problems within a short period. The policy that emerged was to restrict "automatic" drawing rights to only the first 25 per cent of a member's quota: the so-called *gold tranche*. At Bretton Woods no distinction between tranches had been envisaged: each available tranche was to be equally accessible. And instead of the period of use of Fund resources being determined by the eventual restoration of the member's owned reserves—reflecting that its payments deficit had changed to a surplus (or, failing that, if a consultation with the Fund had decided on a method of repurchase)—the Executive Board formally adopted the policy that all drawings were to be repaid within a maturity term of three to five years. Thus, the Fund would not be the institution Keynes thought he had negotiated at Bretton Woods. It would instead operate as a traditional type of credit institution.

These restrictive drawing and repayment policies contributed to a state

of operational near-paralysis during most of the Fund's early years. By the fifties, the Fund was looking for new ways of inducing members to use its resources. On February 13, 1952, the Executive Board decided formally that drawing rights on the gold tranche would be made *so* automatic as to remove all doubts regarding the availability of Fund resources for this one tranche. By giving countries "the overwhelming benefit of any doubt," members could presumably draw against their gold tranche even if they were in payments surplus—with no questions asked. Paradoxical as it may seem, this degree of automaticity would, in my opinion, have been unacceptable to Keynes.

Undoubtedly the Fund considered it necessary to do this. Had it not allowed at least this one tranche to be available automatically, joining the Fund, or increasing the level of Fund quotas, would actually have resulted in reducing, rather than increasing, world liquid reserves—because of the gold subscription (25 per cent of quota) which members transfer to the Fund from their owned reserves.

Access to drawings beyond the gold tranche was made increasingly *conditional*, with more stringent tests for each higher tranche. Thus was born the Fund's present "liquidity" system—a system entirely foreign to the conception of Bretton Woods. There would be far more automaticity of drawing rights against the gold tranche than had been envisaged at Bretton Woods, but far less automaticity than originally intended for drawing rights into the higher tranches.

The Fund, in effect, instituted an "early warning system" for access to all but the first of a country's tranches—an approach requiring that a country, before having access to Fund "credit," must take action to correct its payments position. By contrast, the original Bretton Woods approach had been based on a different conceptual understanding and order of priorities. In brief, the original idea was predicated on the following: (a) There is no sure way to know in advance that a payments deficit will or will not persist, or turn out to be self-correcting. (b) Since deficits have their counterparts in foreign surpluses, their occurrence could be as much a result of policy in the surplus countries as in the deficit countries. (c) To achieve high levels of employment, output, and world trade countries must not be "trigger happy" in the adoption of restrictive balance-of-payments policies. (d) Fund members in good standing could generally be trusted to pursue reasonable policies to the limits of their capabilities; in any event, access to Fund resources would not be unlimited, but, rather, limited to one tranche a year, except in the event of a Fund waiver. (e) In addition to other safeguards, the fact that drawings from the Fund would occur as a member drew about equally from its owned reserves would help ensure that Fund resources were treated with equal regard.

The Bretton Woods attitude toward the possible abuse of Fund resources, therefore, was that the risk was worth taking, for the benefits would be great: IMF quotas could be regarded as virtually identical to owned reserves. Fund quotas would thus be utilized as true liquid-reserve supplements. In any event, the risk of abuse would be relatively small, since in three or four years a consultation with the Fund would come due automatically if restoration of Fund resources had not previously occurred.

It seems to me that some such approach along Bretton Woods lines is a prerequisite to the attainment of Bretton Woods objectives and priorities. The system calls for the creation of liquid balance-of-payments resources so as to reduce the necessity of balance-of-payments restrictions and controls. These resources would be used, and repaid, on a standard (even required) basis as part of an automatic operating procedure, so that there could be no undermining of confidence in a currency associated with that country's use of the Fund. Regular use of the Fund in conjunction with a member's owned reserves would also help to defeat the forces of Gresham's law: countries could not simply unload claims on the Fund for other types of reserve asset, or vice versa.

The original apparatus of the Articles delegates international monetary power (drawing rights) to the Fund's participating members, *not* to the Fund's Executive Board (except for a generally supervisory or administrative role): the Executive Board would generally not intervene between a member and its drawing rights until after a period of protracted use of the Fund's resources. Only then could the Fund recommend policy changes—say, fiscal or monetary measures, or even a currency devaluation.

The original Bretton Woods approach would not have prevented the Fund from extending technical assistance to its members at any time, if they requested it. However, it is also clear that advice on policy from the Fund would carry less weight, as access to Fund resources would not depend on having to live up to the Fund's advice. Accordingly, the new policies adopted by the Fund may have contributed toward the earlier adoption of prudent policies by some of its members, particularly the underdeveloped countries.

On the other hand, the developed countries that are members of the Fund also are subjected to this policy procedure. To them, resort to the Fund carries an unfavorable stigma: there is an unavoidable implication that their resort to the Fund has been made necessary by virtue of their improvident policies. For the Fund, rather than being drawn upon virtually *pari passu* with the use of owned reserves, is now available only after prior review of a member's creditworthiness. Accordingly, high-

income countries shun the use of Fund resources. They put off such use until events force them to submit. And, since they use the Fund only in this limited way, the stigma attached to use of the Fund becomes even more deeply entrenched.

It is partly because of this unavoidable stigma, and the fact that unacceptable conditions might be attached to the use of Fund resources, that the United States refrained from drawing on the Fund for many years, despite the fact that its gold reserves were steadily being depleted. Even today, this country's drawings from the Fund have remained within the gold tranche. The United States, with its major confidence problem as principal reserve center has evidently believed that it could not risk using the Fund for balance-of-payments financing.

The United States, however, has obtained some financial window-dressing from the Fund through a circuitous route by which both it and the Fund lay claim to the same \$800 million in gold. This is a book-keeping device intended to avoid damaging the public image of the United States. It raises two problems, however. First, the game will be up if either the United States or the Fund tries to cash in its claim. Second, there is a loss of dignity: the practice sets an improper example for an international monetary institution which presumes to be entrusted with major world responsibility and power.

Adoption of the Fund's policy approach, as opposed to its original Bretton Woods conception, has not accomplished the intended objective: preventing an abusive use of Fund resources by "uncreditworthy" countries. The "less trustworthy" of the Fund's members have drawn repeatedly on the Fund. Indeed, the less developed countries, as a result of political pressures, have succeeded in introducing a "compensatory facility" in the Fund. This facility permits them to circumvent prior Fund scrutiny for drawings against two tranches in cases where there is a shortfall in export earnings due to exogenous causes. In effect, the compensatory facility reestablishes virtually automatic access to Fund resources for the underdeveloped countries, under conditions somewhat similar to the original intent of the Articles. The Fund was intended to be a compensatory facility for all of its members.

The Fund has been a very useful institution in many ways. However, its policies have led it to be regarded by some observers as a kind of "foreign-aid agency of the United States." Actually, it is as a "foreign-aid agency" that it has had its greatest successes. But the advanced countries of the world neither require, nor seek, assistance of this type. Their need is for a liquid supplement to owned foreign-exchange reserves, so that international trade and capital movements will not be stymied by unnecessary balance-of-payments restrictions. The Fund has become a source of three-to-five-year "program loans"—as they call it in foreign-

aid parlance—a type of lending institution, a world bank. The World Bank, on the other hand, in proposing a supplementary financing facility for export shortfalls, wants to become a kind of monetary fund.

IMF Mechanism for Payments Adjustment

A most serious failure of the Fund has resulted from neglect of the “scarce-currency” provisions of the Articles (Article VII). These provisions were intended as a new and revolutionary approach to balance-of-payments adjustment. The idea was to recoup the lost adjustment mechanism of the nineteenth-century gold standard, whereby flows of gold to the principal creditor countries would produce internal expansionist pressures and tend to increase their foreign lending. Such effects can be neutralized by the techniques of modern monetary management. Thus, the scarce-currency provisions were intended to impose a sharing of responsibility for the burden of payments adjustment by the creditor countries. Otherwise, countries which remained in protracted payments surplus could produce a shortage of other countries’ international reserves, with the entire burden of adjustment then falling upon the deficit countries. A severe reserve shortage might result from such policies, thereby contracting international trade, restricting capital movements, retarding rates of world economic growth, and setting off worldwide recession.

The basic rationale of the scarce-currency provisions was, simply, that no country should be obligated to permit its nationals freely to import the goods of any country whose policies severely restricted the availability of financing for such purchases, that is, resulted in an external “scarcity of its currency.” A formal declaration by the Fund that a currency was scarce would authorize members of the Fund to discriminate against the exports of such a country. Accordingly, countries in chronic surplus, which did not pursue policies appropriate for restoring external-payments balance, or at least extend adequate amounts of capital exports or external assistance, faced the threat of worldwide discrimination against their products.

The grand design of Bretton Woods would thus retain the possibility of trade discrimination in the postwar world. But this would not be the insidious bilateral discrimination associated with Hjalmar Schacht and the 1930’s. Rather, like the possibility of a currency devaluation under the Articles, discrimination would require the sanction of an international consensus—a majority decision of the nations participating in the Fund.

Another important effect of the scarce-currency provisions was to reduce the significance of the *size* of a country’s quota in the Fund as a source of balance-of-payments financing for other countries. The size of the Fund, and especially the size of the United States quota, was smaller

than Keynes had initially sought. However, by virtue of the scarce-currency provisions, this would not reduce the obligation of the United States to provide adequate amounts of external financial outflows: for example, private capital exports, foreign aid, or, perhaps a loan of additional dollars to the Fund. What the United States had gained by its smaller quota in the Fund was a further safeguard against the possibility of a reckless call on its resources. This would be helpful in securing the support of Congress for passage of the Bretton Woods Act. Indeed, a creditor country would receive earnings on its bilateral loans to, or investments in, other countries, whereas a withdrawal of its currency from the Fund would yield no interest. (This was a negotiated compromise: Keynes' Clearing Union would have applied mounting charges to both net creditor and net debtor positions alike. The traditional approach, of course, would have charged interest only to debtors, while creditors would receive interest.) By not paying interest to countries for their net creditor positions in the Fund, chronic reserve hoarders would receive no prizes for their policies.

The adjustment mechanism of the Fund, as designed at Bretton Woods, was a balanced mechanism. Countries in payments deficit would purchase the currency they needed from the Fund in exchange for their own currency. If this ultimately increased Fund holdings of such currency to a *high* level (as determined by the system of Fund charges), a consultation with the Fund would come due automatically. If deemed appropriate, the Fund would then apply pressure on the country to adjust its external deficit. (Of course, the natural pressure caused by running low on reserves would also apply.) On the other side of the mechanism, Fund holdings of currencies withdrawn by deficit countries would decline (thereby increasing the liquid claim on the Fund of the country whose currency was drawn). However, if Fund holdings of such currencies declined to a *low* level, again there would be a consultation, this time to consider whether a condition of currency scarcity was developing. The possible threat of worldwide discrimination against purchases of the products of a country whose currency was formally declared to be scarce would apply pressure on countries in chronic surplus to adjust their external imbalance or increase their capital exports.

Both Keynes and White were highly satisfied with this outcome. Keynes was convinced that no country would pursue policies that might lead to its currency being formally declared to be scarce by the Fund: such countries, instead, would adjust (or, at least, extend adequate external credits). The IMF Articles thereby set the stage for the Anglo-American Loan Agreement, the Marshall Plan, other postwar (bilateral) foreign-assistance programs of the United States, and the freedom of American private capital outflows. (For an indication of the great impor-

tance attached by both Lord Keynes and Harry Dexter White to the scarce-currency provisions, see excerpts from Keynes' address before the House of Lords on May 23, 1944, and an article by White in *Foreign Affairs*, January 1945.)

Though not expressed explicitly in the Articles, a decline of Fund holdings of a member's currency to 15 per cent of quota was mentioned informally as calling for a Fund study of whether a scarcity of a currency was developing. Since drawings from the Fund would consist of the particular currencies members specified as needed (for financing balance-of-payments deficits), low holdings of currency by the Fund would be indicative of countries in protracted payments surplus. (Even if members simply drew the currencies that yielded the best exchange profit—by drawing [at par], and then converting on the market currencies selling at the highest premium prices—the level of currency holdings by the Fund would still function properly: market premia also tend to reflect currencies of countries in strong payments surplus.)

A Fund report on currency scarcity would be optional, and the Articles require that a representative of the affected country participate in its preparation. In making its recommendations, the Fund would consider whether the policies of the country whose currency was growing scarce were appropriate for dealing with the situation. The Fund could not dictate policy recommendations at the first sign of an external surplus: again, there was to be no "early warning system." The Fund would have to wait until its holdings of a particular currency had been reduced to a low level relative to the member's quota. The privilege of discrimination upon a formal finding of scarcity would continue until such time as the Fund deemed the scarcity to have ended.

Erosion of IMF Adjustment Mechanism

The originally balanced mechanism of the IMF Articles for payments adjustment was destroyed with the demise of the scarce-currency provisions. This took place in two stages. The first occurred during the postwar "dollar shortage," when there was a considerable amount of "corridor activity" aimed at warding off any possibility that the Fund might even consider reporting the dollar as a scarce currency. It is my impression that those responsible felt it would be a mistake to declare the dollar scarce, since such an act could mislead the world into thinking the United States was not acting responsibly and appropriately. It is clear that, at the time, there could have been no apprehension about the possibility of worldwide discrimination against American products: virtually all countries were already doing it. (The Fund authorized such restrictions during the transition from wartime conditions [Article XIV].) Furthermore, the United States had extended the Anglo-American Loan, and

adopted the most generous programs of external assistance, such as the Marshall Plan, that had ever been devised by man. Had the Fund acted under its scarce-currency provisions, it is inconceivable that a report critical of the United States could have been produced. (As mentioned previously, the Articles would have required that a representative of the United States participate in the preparation of any such report.) The most likely outcome of a Fund study would have been a report that approved, rather than criticized, American policy.

Obviously, some risks are an unavoidable aspect of delegating power to an international monetary consensus. Unless participating countries are prepared to accept some degree of risk, such an arrangement cannot be effective. By preventing the Fund from acting under its scarce-currency provisions, one of the most important delegations of power originally entrusted to the IMF at Bretton Woods was returned to the sovereign countries.

The second stage in the demise of the scarce-currency provisions came in July 1962, when the Executive Directors of the IMF formally approved a change of policy concerning the currency composition of drawings from the Fund. According to the new policy, members wishing to draw from the Fund no longer were to specify the particular currency they needed (in accordance with the Articles) subject only to a majority vote of the Executive Board (reflecting the weighted voting power of all Fund members). Instead, under the new policy, the Fund would provide financing to a drawing member in the form of a "basket" of currencies. The currencies supplied would be determined by the Managing Director, who would consult "informally" in advance with each potential creditor country to obtain its special consent as to the use and amount of its currency in any drawing. The choice of currencies to be included in the basket would be "guided" by what the Fund considered to be the strength of the member's balance-of-payments or reserve position; that is, the Fund would avoid loading the basket with "weak" currencies. It would, instead, supply relatively larger amounts of "strong" currencies. The drawing member could then subsequently convert the basket of currencies received from the Fund for the currency it really needed, but outside the Fund.

This policy decision wrecked any remaining semblance of the original mechanism of the Articles for activating the scarce-currency provisions. Since drawings from the Fund would not consist of currencies the drawing country needed, the natural link between currencies drawn and countries in protracted payments surplus was broken. A low level of Fund holdings of a currency could no longer be indicative of whether a scarcity of that currency might be developing.

The fact that many countries might almost always have drawn dollars

from the Fund would not have disturbed the mechanism. For under the original design of the Fund, the United States could have reversed these drawings if its owned (gold) reserves were declining; that is, it could have swapped dollars for the currency it required to protect its gold holdings. Under the new policy the United States, like other Fund members, lost the power it formerly had to specify the currency it needed from the Fund. The new procedure, in effect, shifted this power from the deficit countries to the surplus countries, with the Fund management acting as agent.

Other Effects of Fund Policies

The new Fund policy on currencies to be drawn introduced, in effect, a second round of voting in the Fund, under which a member could informally veto the use of its currency in Fund transactions. Since this new power was introduced at a time when European currencies had become more useful, it made possible a further significant shift of international monetary power towards the Continent. One serious consequence of this decision with respect to American interests is that it introduces possible doubts about the availability of Fund resources in the event of a future need for a large drawing by the United States.

A far more serious consequence of this policy from the American standpoint arises from its function as reserve center. Nonreserve-currency countries may draw convertible currencies, such as marks and liras, from the Fund, without particular inconvenience; they can easily convert these currencies outside the Fund into the reserve currency they require—perhaps even at a profit. However, suppose that the United States needs the assistance of the Fund because the central bank of a particular country no longer desires to hold dollars. Other countries may not share this desire. Yet, if the United States draws a basket of currencies, rather than only the currency of the country holding “excess” dollars, its conversion of the Fund’s basket outside the Fund would be likely to reduce the dollar holdings of the wrong central banks. In the meantime, the dollars of the country holding an excessive amount may be converted into U.S. Treasury gold. The Fund’s policy on currency composition of drawings, therefore, handicaps the potential effectiveness of the Fund for use by the United States.

Another serious defect of this policy is that it contributes to an undermining of confidence in the dollar. By virtue of this policy, the IMF avoids drawings of currencies it considers to be weak. When regarded in a vacuum, the policy makes sense: it is clearly intended to avoid further additions to the international supply of a currency which the Fund regards as already in excess. But there is also an unavoidable consequence, namely, to put the single most important authority on international

monetary affairs, the Managing Director of the Fund, in the position of taking actions which, by their very nature, brand the dollar as a weak currency. Thus the highest monetary officials in all countries, who are exceedingly sensitive to such matters, namely, the central bankers, receive signals from the IMF Managing Director which undermine confidence in the dollar. When this policy was first launched by the Fund, a typical reaction of central bankers on hearing that *the American balance of payments was weak* was one of disbelief. "Is it really true," they asked members of the Fund staff, "*that the dollar is weak?*"

To hold that this policy did not undermine confidence in the gold convertibility of the dollar is to imply that the Fund's view of such an important matter is not taken seriously. The question regarding the effect of this policy is not whether, but by how much, it raised the proportion of gold central bankers would hold in their official foreign-reserve balances. Even relatively "small" shifts out of dollars into gold can create a serious disturbance, as the gold stocks of the U.S. Treasury are limited.

It is *not* that the Fund was trying to weaken the dollar when it adopted its policy on currencies to be drawn. The original Bretton Woods concept of the Fund acting as a source of regularly used liquid supplements to international reserves had been destroyed by previously adopted policies. The Fund had become an international lending agency of foreign-aid type for the developing countries, and a bail-out facility of last resort for the developed countries. As such, advanced countries could not use the Fund as a supplement to their owned reserves. Only when their situations seemed desperate would they resort to the Fund. In this situation, drawings of their currency from the Fund had become akin to an extension of foreign aid—a "contribution"—leading to a *loss* of reserves. Thus, advanced countries desired the right of prior consent to drawings of their currencies from the Fund. They obtained this right in the new informal veto procedure. The use of a member's currency by the Fund had become a "burden" to that member. The Managing Director, therefore, would attempt to allocate this burden among the "stronger" currencies. In the case of the United States, however, the reduction of its burden was offset by creation of another burden—an undermining of confidence in the dollar.

In October 1962, the Fund, faced with near exhaustion of its funds usable for loans—at least if large drawings by the United States and the United Kingdom might have to be satisfied—agreed to the establishment of the so-called General Arrangements to Borrow. The new arrangement accorded further recognition to the shift of international monetary power to Europe. The major industrial countries formed the Group of Ten—empowered to determine when and if any of the members of the Group should have access to an additional supplementary fund of \$6

billion for balance-of-payments financing. Creating this arrangement outside the IMF was a further demotion of the Fund. The Group of Ten became an exclusive club for the high-income countries, leaving the Fund with its foreign-aid and bail-out operations for the weak sisters. Formation of the Group of Ten further increased European international monetary power, as the United States relinquished the advantage of its weighted vote in the Fund, as well as the support it traditionally received from the vote of the low-income countries. There was, in effect, a formal fracturing of the IMF, which I believe to have been a major contributing cause to the later formation of the UNCTAD (United Nations Conference on Trade and Development). In the UNCTAD the low-income countries could still be heard. It served at least partly to counter-balance formation of the Group of Ten.

Perhaps the ultimate in the postwar shift away from the original IMF mechanism was the creation of the complicated proliferation of central-bank "swap" arrangements and so-called "Roosa bonds." These arrangements provided for the provision, *or denial*, of balance-of-payments credits outside the Fund on an *ad hoc*, bilateral, country-by-country basis. International monetary power, rather than being exercised through the IMF arrangement, would clearly shift to the creditor countries. Undoubtedly the United States was forced by circumstances to negotiate these arrangements. As a major reserve-currency country—based on fractional (gold) reserves—the United States could not afford to risk a loss of confidence attendant on use of what had become of the Fund.

Resulting IMF Status

Thus, the Fund has not been the international monetary institution originally envisioned and negotiated at Bretton Woods. It does not create *liquid* international reserve supplements through periodic quota increases. It does not exert balanced pressure on surplus and deficit countries alike to correct their payments imbalances. It has, instead, become an agency which creates "burdens" for advanced countries, and which cannot be used by them except after other alternatives have been exhausted. The impotence of the Fund does much to explain recent efforts of the United States to reform the existing international monetary system.

Analysis of highlights of the evolution of IMF policies concerning the Fund's liquidity-creation and adjustment mechanism, as presented in this essay, has by no means been exhaustive. For example, no mention is made of the stand-by technique, the method which, since 1953, has become one of the most important procedures for utilizing Fund resources. The reason for the omission is, simply, that the principal

concern of this essay is not with technique, but with matters of conceptual importance. The primary importance of the stand-by system is as an operational technique. But there is no fundamental change in the role of the Fund. The stand-by technique does not alter the fact that the Fund remains a source of bail-out credit for the developed countries, and a foreign-aid agency for the developing countries. (Indeed, the fact that in 1964 the United States considered it necessary to obtain a Fund stand-by even on its gold tranche further underscores the problem it must overcome before being able to take the Fund seriously, with or without stand-bys.)

By comparison with the "grand design" at Bretton Woods, the existing international monetary order provides far less assurance of monetary stability. The intended liquidity mechanism of the Fund has been wrapped in a maze of "gold tranches," "super gold tranches," "credit tranches," "stand-bys," "compensatory financing," "creditworthiness," "3-to-5-year repayment rules," "contributions," "General Arrangements to Borrow," "overwhelming benefit of any doubt," and so forth. This lexicon, impressive as it may seem, did not exist at Bretton Woods. None of it can be found anywhere in the IMF Articles of Agreement. On the other hand, important provisions of the Articles, such as "scarce currency" (Article VII), "purchase" and "repurchase" of currency [Article V(3)(a)(i) and V(7)(b)(i)], "confidence" of availability "under adequate safeguards" of Fund resources "to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" [Article I(v)], might just as well not have been written. They simply have little or no relevance to today's International Monetary Fund.

The result is that gold transfers from the United States, persistent foreign surpluses, and policy changes in the IMF system have tended to shift international monetary power to the countries in chronic surplus—the reserve hoarders—and away from the reserve-currency centers and other countries. As a result, the system grows increasingly vulnerable to *ad hoc* influences. National political, rather than economic, considerations dominate the availability of balance-of-payments financing. The power to attain major world objectives, as envisioned at Bretton Woods, has shifted to countries with a different order of priorities.

The legal basis for a more powerful IMF still remains in its Articles. Acts of policy, rather than acts of amendment, have reduced its scope for a balanced and effective Fund. To sweep away the policies which have evolved in the Fund would not be impossible, since they are based on, and could be changed by, the (weighted) majority vote of the Executive Board. However, there is now on the scene a proposal for adding the "SDR" (Special Drawing Rights) to the IMF lexicon.

Unlike the other members of this word list, the new facility would require a major amendment of the IMF Articles. Should this occur, the legal authorization for Fund policies—based up to now on majority votes of the Executive Board—would also be changed. Changing the Fund back to the original Bretton Woods mechanism for liquidity creation and balanced payments adjustment then also would require an amendment of the Articles. Such acts of amendment require legislative approval by countries accounting for more than four-fifths of the (weighted) Fund voting power thus a 20-per cent veto could bar a return to the original Bretton Woods system. The question arises whether the SDR is superior to feasible alternatives. We shall examine this facility, especially as it affects the international monetary power structure. (A comprehensive analysis of its technical structure and operation may be found in Fritz Machlup, *Remaking the International Monetary System: The Rio Agreement and Beyond.*)

The SDR Facility: Status of Agreement

On August 26, 1967, the Finance Ministers of the leading developed countries, meeting in London, reached agreement on the outline of a new process for “creating gold out of paper.” Mr. Fowler, Secretary of the U.S. Treasury, called the occasion “one of the great days in the history of financial cooperation,” the culmination of “the most ambitious and significant effort in the area of international monetary affairs since Bretton Woods.” President Johnson termed the new agreement “the greatest step forward in world financial cooperation in the 20 years since the creation of the International Monetary Fund itself.” In a resolution adopted unanimously on September 29, 1967, the IMF Board of Governors, meeting at Rio de Janeiro, directed the Fund’s Board of Executive Directors to draft such amendments to the IMF Articles as are necessary to incorporate the proposed SDR facility within the Fund.

At least two major issues of the plan, namely, the amounts of special drawing rights (liquidity) to be created and the timing and conditions for activation, were not agreed to at London. All that was agreed on was the outline of one of any number of possible techniques for creating international liquidity. By way of contrast, the agreement reached at Bretton Woods in 1944 clearly spelled out in advance the amount of each member’s initial quota when the IMF Articles came into force. In the present instance, not only does it remain undecided what amounts of SDR’s are to be created, but the Continental Europeans have stated their intention that the new facility shall not be used to finance the two major reserve-currency countries so long as they remain in deficit.

Continental Europe fears domination by the United States and is not anxious to give up the power advantage it has acquired under the exist-

ing arrangements of the international monetary system. From the European point of view—that of countries in chronic surplus—there is no general inadequacy of international liquidity. The Americans, feeling a shortage of liquidity, have had to be “supplicants” vis-à-vis the Europeans. Bretton Woods was intended to prevent this sort of situation, but the Fund has not functioned as designed. As Henry B. Russell put it seventy years ago, the United States has again had to revert to “the old pastime of importuning Europe.”

Although, at the time of writing, the final technical details of the proposed amendments of the IMF Articles were not yet worked out, I believe that analysis of what already has been decided will prove sufficient to warrant rejection of the proposed facility.

Highlights and Analysis of the SDR Mechanism

According to the outline of the plan, special drawing rights would be allocated to Fund members on an annual basis, in proportion to their regular Fund quotas. If and when the plan were activated, countries could exercise their drawing rights, when they had a balance-of-payments need, by exchanging SDR's for a package of currencies convertible “in fact.” The placement of SDR's for a deficit country would normally be directed by the Fund management to “participants that have a sufficiently strong balance-of-payments and reserve position, although SDR's could also be placed with a country bilaterally.” *Over the long run*, the Fund would seek to approach equality in the ratios of members' holdings of SDR's to their owned reserves. Countries using the full amount of their original SDR allocations, would incur an obligation to “reconstitute” their special drawing rights—say, by not utilizing SDR's in the last years of the five-year basic period—to the extent that their drawings had exceeded an average of 70 per cent of their original SDR allocation. No country would be obligated under the arrangement to accept additional SDR's in excess of twice its original allocation. Like quotas in the regular Fund, SDR's would maintain constant value in terms of gold, but would not be redeemable (on demand) into gold. As is now the case, a system of charges would require countries making net use of SDR's to pay interest costs. However, unlike the present Fund system, creditor countries would receive interest on their net SDR positions. Thus, the new facility would reestablish the traditional treatment of creditors—paying them income for accumulated (net) reserve positions.

The period during which SDR's would be allocated, following a decision to create them, would normally be five years. The IMF Managing Director would make proposals for creating SDR's after having consulted with Fund members to determine that there was “broad

support" for such action. Decisions on the basic period, timing, amount, and rate of SDR allocations would require an 85 per cent majority vote of participants. However, reductions of SDR allocations from levels initially agreed, or cancellations, would require only a simple majority vote.

The United States quota in the Fund, being approximately 25 per cent of total IMF quotas, would entitle it to receive some 25 per cent of the total SDR's created. If the amount of SDR's allocated should amount to, say, \$1 billion a year for five years—which is a figure often mentioned as a possibility—this would provide some \$250 million annually in drawing rights to the United States. However, since 30 per cent would have to be reconstituted if all drawing rights were fully used, the effective allotment to the United States out of an allocation of \$1 billion would amount to about \$175 million per year. Accumulating the (real) 70 per cent allocations over a five-year period would give the United States some \$875 million in total SDR's by the fifth year. This five-year accumulation may be compared with a single U.S. tranche in the Fund under its regular quota system of \$1,290 million. If the total annual allocation of SDR's were \$2 billion, rather than \$1 billion, the effective allocation to the United States would be \$350 million per year—accumulating to \$1,750 million by the fifth year.

As mentioned previously, 85 per cent of the voting power of the 107-nation Fund would have to agree on the amounts and timing of the new liquidity to be made available. The European Economic Community, holding about 17 per cent of the total IMF voting power, would gain a veto on decisions to create SDR's if it voted as a bloc. This would enable the EEC to set the ceiling on amounts of SDR's to be generated, or even to prevent access to any new liquidity at all. The United States, with a quota of almost 25 per cent, would continue to have the power of veto. Since cancellations (or reductions) of previously agreed SDR creation would require only a majority vote, a possible move in this direction could not be stymied by a 15 per cent veto.

Some observers, such as former Under Secretary of the Treasury Robert V. Roosa, are reported to regard the insistence of the Europeans on a veto to be "trivial," on the grounds that no international liquidity facility can succeed without European cooperation, with or without the veto. Edward M. Bernstein, former IMF Director of Research, is also untroubled by the veto, contending that any fear of insufficient creation of SDR's because of "excessive caution on the part of the Common Market countries" is wholly unjustified.

Frankly, I am at a loss to understand the positions of these gentlemen. With respect to Mr. Roosa, the existing international monetary situation cannot be considered a success, largely because the present system imposes

no pressures on countries in chronic surplus to adjust their external payments positions or, at least, to extend additional loans or other financial assistance to other countries. Indeed, by refusing to cooperate, that is, by not adopting policies that would *share the burden* of external adjustment, countries in chronic surplus can further strengthen their international monetary power. The veto provision would "permanently" establish a formal EEC right *not* to cooperate: it supplies a new legal basis on which Continental Europe can dominate in the Fund. Real reform of the international monetary system should have made it more difficult, rather than easier, for countries in chronic surplus *not* to cooperate.

Mr. Bernstein, it must be noted, does not deny that the EEC will keep the creation of SDR's "far below the needs of the world economy." He merely rejects the notion that it would do this because of "*excessive caution*." But there are obviously other motives, political and economic, that can be expected to produce foot-dragging by the EEC on the question of SDR creation. The appropriate question is not whether the EEC will agree to SDR creation, but at what cost?

Assuming France eventually will ratify the SDR facility, the argument is made that its power to produce a unanimous vote in the EEC is probably on the decline, and that after de Gaulle the French position will be cooperative and moderate. In addition, the rest of the EEC will supposedly be less willing to accept domination from Paris once the most delicate phases of market integration are successfully completed. Thus, it is argued, there is no reason for concern that the EEC might stymie SDR creation.

This line of argument is unconvincing, for the following principal reasons:

(a) the first and *least* important reason is that it is not possible to foretell the political situation in France (or anywhere else for that matter) over the time horizon appropriate for consideration of the SDR facility, namely, at least the next two decades. For all we know, the current signs of a trend in France (and in Germany) toward the polarization of political power will continue; if so, there would be more radical and perverse governmental behavior, not less. In any case the "permanent" framework of the international monetary system must be constructed on a sounder basis than that of political crystal-ball gazing.

(b) Second, and more important, moving to a 15 per cent vote as veto power over SDR creation must be judged in a broader context. It is not simply a question of acceding to EEC demands. The fact is that there is nothing to prevent *any country* from voting on either side of any question. As the power of veto proliferates, the potential for abuse increases. This potential does not end at EEC borders. A combination of France, India, and the Arabian-African bloc (or, dropping India and picking up

Germany, and so forth) could also defeat a motion to create SDR's. In the next 20 or 30 years, there could well be groupings of countries which considered it in their national interests to block increases of SDR's. Requiring an 85 per cent vote for SDR creation constitutes an open invitation to engage in international monetary blackmail. "Hard core" surplus countries can be counted on for some (if not all) of the necessary 15 per cent—indeed, for them the question is not scarcity but excess supply of international liquidity—making it easier for irresponsible countries to achieve their ends. The potential for "pay-offs" is evident and inescapable.

The Managing Director of the Fund (among others) has noted that "(T)here is not now, and probably never will be, any scientific method of gauging precisely the global need for reserve growth. The effects of supplementing reserves are difficult to assess, and may be differently evaluated by good judges in different countries, or within the same country. Consequently, the lack of agreement as to whether there is or is not at the present time a need to supplement reserves is something that should not surprise us." (Arthur K. Salomon Lecture, December 5, 1967.) I agree with the Managing Director, and would note that a negative judgment by only 15 per cent of the voting power of the Fund would be sufficient to block SDR creation.

Although the power of veto technically extends only to decisions on SDR creation to be made once every five years or so by the IMF Governors, there should be no illusion about the fact that the strength of the EEC veto would also be reflected in day-to-day Fund operations. Surely any Managing Director would be especially concerned about seeing that the Fund is managed in accordance with EEC wishes. No Managing Director could fail to take the power structure of the Fund seriously.

The strength of the present power base of the United States in the Fund has always been felt in day-to-day operations. The Fund's management knows it has the United States to thank for the resources it manages. Although formal votes are rarely taken in the Fund's Executive Board, all Fund decisions reflect the power of American influence. Even the tradition of unanimous votes in the Fund Board, for the relatively infrequent occasions when votes are taken, reflect this influence.

We have had no experience with a power structure in which the Fund management had the EEC to thank for the resources it manages. If the policy aims of the Europeans and the United States were very nearly the same, then the fact of where the Fund's resources came from would not be an important consideration. However, the EEC and the United States differ in their aims and outlook. Europeans tend to be reserve hoarders; their perspective is more inward-looking and narrow than that of the United States. The traditional advocacy of freer trade and pay-

ments by the United States since the mid-30's, and its desire to assist in the economic advancement of the developing world, are far more consistent with the global aims and aspirations expressed at Bretton Woods. It is tragic that in the name of its balance-of-payments problem—a situation in which surplus countries are under no pressure to adjust—the United States has adopted a series of policies which contradict these aims.

I expect that the new EEC power base would result in significantly more restrictive Fund policies, extending far beyond the operations of the SDR facility. I base this judgment largely on the fact that the two separate facilities—the regular Fund and the SDR—cannot conceptually be divorced from each other. It is impossible to imagine that either of these facilities is not some sort of substitute for the other. An increase in SDR's would tend to preclude, or to reduce, increases in regular Fund quotas, and vice versa. More automaticity for the SDR facility means an even less automatic regular Fund. These observations apply whether or not the EEC succeeds in attaining its so-called "parallel demands" which, among other things, would formally apply the 15 per cent veto power to regular quota increases—further evidence of the unbalanced monetary power structure.

Even the United States would not regard the regular Fund very differently from the Europeans. The more the United States was inclined to view SDR's as useful for its purposes, the less concerned would it be about the regular Fund facility. United States national interests would no longer be directly at stake in the regular Fund.

Further Clarification of IMF-SDR Comparison

More confusion than light has been shed on the SDR facility. In innumerable press reports and magazine articles it has been called a wonderful new "paper gold," "the world's first truly international currency," and so forth.

But the Fund, as originally designed, was to have created reserve supplements equally as useful as international currency. The standard of comparison for the new SDR has been the IMF that *is*, not the IMF that was *intended* at Bretton Woods.

The present IMF considers that it *creates* international reserves. For example, the IMF Managing Director has asserted (in the lecture cited earlier) that ". . . gold tranche drawing rights are interesting in that they are the first example of *reserves created by an international institution* and usable to meet payments deficits incurred in any part of the world." (Emphasis supplied.) But gold-tranche drawing rights consist of two components: (a) the amount by which the member's owned reserves were reduced when it paid its gold subscription to the Fund

(25 per cent of quota when fully paid). Obviously, there can be no *net* "reserve creation" produced by this element of gold-tranche drawing rights. (b) The second component consists of the liquid claims of members on the Fund which arise from drawings of their currencies by other members. Now the strange thing about "creating reserves" (unconditional liquidity) in this manner is that it, too, really does not happen. What actually does happen is that while (nonreserve-currency) countries may receive increased gold-tranche drawing rights on the Fund by virtue of their currencies having been drawn by other members, they may lose owned reserves approximately equal to their new claim on the Fund. For, and this is often overlooked, the drawing country usually exchanges the basket of currencies it receives from the Fund for the reserve currency it needs (unless the currency drawn is already a reserve currency.) Assume, for example, Brazil wants dollars but, because of Fund policies, gets marks, francs, and liras from the Fund. It will then generally swap these currencies for dollars with the central banks of Germany, France, and Italy. The latter's owned balances of dollar reserves go down, thus offsetting the increase in these countries' claims to new "reserves" in the Fund.

In comparison with the *present* IMF liquidity mechanism—which does not really create international reserves but, primarily, changes their composition (from owned reserves to drawing rights on the Fund)—the *valid* point is made that the SDR facility would *create* international liquidity—that is, reserve supplements, which, once created, "would never be destroyed." But the facility originally designed at Bretton Woods would have done the same: IMF reserve supplements to owned reserves were intended to be created when IMF quotas were increased. These too, once created, "would never be destroyed."

J. J. Polak, IMF Director of Research (writing in *The Banker*, November 1967), argues that the structure of the SDR facility "is superior to the liquidity structure of the present Fund" because countries would be obligated to accept twice their original SDR allocation (from other countries), whereas under the present Fund, "total drawing rights exceed total contribution (quota)."

It is true that the Articles entitle members of the Fund to drawing rights of up-to-five tranches before requiring a waiver for further drawings (after drawing five tranches, Fund holdings of currency reach 200 per cent of quota); whereas, countries supply financial resources to the Fund equal to their quota, that is, only four tranches. However, one of the five tranches of drawing rights on the Fund consists of that member's own gold subscription, which, of course, reduces its owned reserves. Thus the Fund, as originally designed, would create *reserve supplements* equal to only four of the member's five tranches of drawing rights. This

means that the drawing rights *gained* by all members on the Fund, as such, are *equal* to their total quota—their total contribution to the Fund—and are not in excess of quota. The formal liquidity structure of the present Fund, therefore, is not unbalanced, as is suggested by Polak's remark: each member of the Fund contributes as reserve supplements for other members precisely what other members contribute for it.

The fact of the matter is that the whole comparison is academic. Drawing rights against Fund liquidity, as set out at Bretton Woods, are not really available as drawing *rights*. Fund policy has made all but one of the five tranches illiquid, that is, only conditionally available. Indeed, when the facts of the present Fund are considered, the assertion might be made with some validity that the liquidity structure of the present Fund is far "superior" to that of the SDR facility. For the present Fund provides drawing *rights* only to one tranche, the one the member contributes from its owned reserves. Beyond that there really are *no* drawing *rights* at all. There are only conditional Fund credits. The Fund can choose to make such credits, or choose not to make them. Thus, total Fund resources exceed *drawing rights* to liquid-reserve supplements by an infinite ratio, and not by just a multiple of two—the ratio representing the amount of SDR's countries will accept from other countries relative to their own drawing rights (original allocations)—as in the proposed SDR facility.

Polak's liquidity comparison implies not the Fund of today, but the Fund that was intended and does not exist. However, the difference between the SDR facility and the one designed at Bretton Woods—which is of fundamental importance—is the fact that the SDR facility puts no further obligation on surplus countries. The amount of their pledge to accept SDR's constitutes the full extent of their obligation. This was not the case at Bretton Woods. The concept behind the SDR facility involves no pressure to eliminate chronic surpluses or extend bilateral credits. Reserve hoarders can simply accumulate SDR's, thereby gaining interest earnings and increasing their international monetary power—a very different system from that envisaged at Bretton Woods.

Contrary to a widely held notion—that a persistent external surplus produces undesirable domestic price inflation—it is at least theoretically possible, through an appropriate fiscal-monetary policy mix, to attain external surplus and internal (full-employment) equilibrium simultaneously, without involving a greater burden of price inflation than would otherwise occur. Achieving such an objective, of course, would affect the allocation of real resources. However, the attainment of external surplus and internal (full-employment) equilibrium simultaneously probably presents little, if any, more of a challenge to the policy makers of an advanced industrial economy than the attainment of simultaneous equi-

librium in both accounts. The SDR system does nothing to change the fundamental weakness of the *present* international monetary system—its lack of penalty for reserve hoarding. Indeed, by paying interest to net SDR creditors, and by amending the IMF Articles to increase their voting power, it would even further reinforce the tendency to hoard reserves.

The SDR scheme also retains the objectionable feature of the present IMF policy on currencies to be drawn, under which the Fund, in effect, asserts that the U.S. dollar is weak. Until such time as the world may have a better alternative than the dollar as international money, it simply will not do for the Fund, as center of the international monetary system, to pursue policies which, by their very nature, undermine confidence in the dollar.

It may be appropriate to consider a possible objection to the originally designed system for currencies to be drawn. The objection centers on the fact that, under the Bretton Woods approach, countries would usually specify the *dollar* as the currency needed from the Fund “for making in that currency payments which are consistent with the provisions of this Agreement.” [Article V(3)(a)(i).] The United States would then draw the currencies of other countries, in the event it were losing (owned) reserves (gold). The objection to this procedure is that the United States, rather than the Fund or other countries, would have excessive power to determine what currencies were to be drawn, and, therefore, which countries were to be creditors to the Fund.

The basis for this objection arises because of the way in which the Fund has developed. As mentioned previously, advanced countries regard the drawing of their currency from the Fund to be a burden. The Fund was intended to be a creator of *reserve supplements*, not a creator (and allocator) of “burdens” among countries. If operations of the Fund were as originally designed at Bretton Woods, countries would not be burdened by drawings of their currency. Their international liquidity would not be diminished by the use of their currencies by other Fund members.

Unlike the intended Bretton Woods mechanism, which (implicitly) *requires* that the Fund be used in conjunction with use of a member's owned foreign-exchange reserves, the proposed facility would not be subject to such use. Countries would have to decide which to use first, their owned reserves or SDR's. This implies two problems: first, there is the problem of “instant availability,” that is, the possibility that countries might dump all their SDR's at the first sign of a deficit. Anxiety about this possibility undoubtedly exists in the minds of the Continental Europeans. It would explain why a high policy official of the United States was reported in the press as considering it necessary to avoid using

the new facility: the idea was to prove good faith to the Europeans. Second, and related to the first problem, is the fact that anxieties created by "instant availability" will lead to smaller amounts of SDR creation—especially in view of the 15 per cent veto. The original Fund system, by limiting annual drawings (without waivers) to 25 per cent of quota, would have avoided these problems.

All in all, I am forced to the conclusion that adoption of the proposed SDR facility as an amendment of the IMF Articles would involve such important "cons" as to far outweigh the "pros." The new SDR facility would reinforce the international monetary-power structure that has led to contemporary monetary and payments difficulties. The world has muddled along in this situation for some years. But the transfer of capital to the underdeveloped countries has fallen increasingly short as requirements have grown more urgent. The reserve position of the United States steadily weakens. An end to the Vietnam situation might slow this trend, but not reverse it under the current dual international monetary arrangements. The United States has imposed progressively more obnoxious restrictions on itself as the persistent gold drain has increased. We must investigate other alternatives.

The Alternative to SDR's

It is not as if there were no alternative to SDR's except chaos, so that we must judge the SDR facility against such a standard of comparison. The fact of the matter is that no country desires international monetary chaos. Indeed, to the United States, such an eventuality would be less serious than to other countries. But this not an appropriate way to describe the situation if SDR's were to be rejected. In the extreme case of a sharp break with European cooperation—which would serve neither their interests nor those of the United States—the dollar could be left to float with respect to other currencies. This would not necessarily imply a system of fluctuating exchange rates, because countries would not tolerate such a system in view of the effects it might have on the international competitive position of their industries. Some of the European countries might impose controls on the dollar. But this is precisely what the United States has been doing under a system in which countries in chronic surplus are under no compulsion to adjust.

Balance-of-payments policies of the United States have had an unfavorable impact on the entire world economy, which grows increasingly more adverse over time. Each new balance-of-payments measure contains uneconomic elements of protectionism—some involve narrow American interests, such as the tying of foreign aid and proposed restriction on foreign travel, and others involve narrow foreign interests, such as the restraints on private capital outflows. All such restraints produce vested

interests in their "permanent" retention, and are in the nature of highly inefficient selective controls. Since nothing in them would alter the fundamental causes of this country's problem (for example, the reserve-currency function based on only fractional reserves, internal inflation, and so on), they can produce only ephemeral improvements. Accordingly, the problems will return, and on each such occasion the policy makers must begin from a more restricted set of conditions than existed before. If the United States swept away its payments restrictions, it is true that some countries might erect new restrictions in their place. Even so, this would tend to be an improvement over the current situation. For at least some countries that would prefer to be free of them are now caught in the net of American restrictions. Also, the costs of restrictions to the countries imposing them would be made more clearly evident as other countries benefited from more rapid rates of economic growth. Thus, significant forces might soon be set in motion to effect their removal.

The stability of any international monetary system is the business of all its participants, surplus and deficit countries alike. If major surplus countries do not see it that way, this does not require that the United States alone do all the cooperating. Given the establishment of a formalized veto under the SDR, however, such a notion would become more firmly entrenched.

There is another system of international liquidity creation that is both feasible and far better suited to meet world needs for a stable international monetary system. It consists, simply, of the mechanism of adjustment and liquidity creation originally intended at Bretton Woods. Some technical improvements (not here discussed) might be made to the originally designed mechanism, but these would be relatively minor; they would *not* constitute "international monetary reform." The United States should formally propose the adoption of this mechanism in the Executive Board of the Fund.

Rather than create a new power base for the EEC, *the United States should give up its own veto power in the Fund.* It does not need the veto. The large size of its weighted vote, and the fact that the international monetary aims of the United States are more closely linked, than EEC aims, with the aspirations of the rest of the world, leads to a traditional, overwhelming majority consensus in the Fund. The added strength of a veto power on major Fund matters—such as general quota increases—adds little, if anything, to the international monetary power of the United States. It does create a serious problem, however, because other major countries or country groups also desire a veto.

Giving a country or group of countries the veto power over creation of international liquidity is analogous to the situation—analyzed above

under the pure reserve-currency system—of requiring that the reserve center eliminate its payments deficit to satisfy the desires of a disgruntled participant in the system. Such a requirement is inappropriate, as it would necessitate an arbitrary reduction in the international money supply of the rest of the world. The same holds true in the case of the deliberate creation of international money: a disgruntled country should be permitted to opt out of the system, rather than be given veto power to block creation of international reserve supplements. This principle applies regardless of how the right of veto might be obtained, that is, whether by “sale” (a special increase in a country’s IMF quota) or, as now proposed, by raising the required majority for liquidity creation to 85 per cent of the voting power.

If the required vote for raising the level of Fund quotas were reduced from the present four-fifths to, say, two-thirds, then no country would hold a veto to which another country, or group of countries, could claim an equal right. More importantly, proliferating the number of countries that have access to the veto power is a highly dangerous step in the wrong direction, particularly with respect to the longer-run interests of the world. The efficient functioning of any international monetary system depends on cooperation, not the opposite.

The above recommended actions would represent a bold new initiative of world leadership by the United States. The question of assessing the feasibility of these proposals goes beyond merely technical considerations. Indeed, technically, the return to the liquidity and adjustment mechanism designed at Bretton Woods would be simple, far simpler even than adopting the SDR facility. Only a change of Fund *policy* is required: the system is already legally authorized by the IMF Articles of Agreement. However, in reality, adoption of these proposals could meet with stiff resistance: by the Europeans with respect to the revision of Fund policy, and by the U.S. Congress with respect to the unilateral release of the American veto power.

A move by the United States for a return to the liquidity and adjustment mechanism of the IMF Articles would provide an opportunity to test the hypothesis of those who have strongly argued, in advocating adoption of the SDR facility, that the EEC could not long resist the overwhelming will of the rest of the 107-member Fund to create SDR’s. Unlike the unrealistic assumption that such a confrontation would occur under the SDR system, there would, in fact, be such a confrontation should the United States take this proposed initiative. The EEC can be expected to resist adoption of the original liquidity mechanism of Bretton Woods, because under that system it would lose international monetary power.

The proposed reduction of the required majority for increasing Fund quotas from four-fifths to two-thirds, would necessitate legislative action by the Congress, as well as by other national legislatures. To obtain Congressional support, the Administration could make the case that the veto in the Fund had become a dangerous anachronism. Enacted in the days of the "dollar shortage," the need for it has long since passed. Retaining the veto in the Fund serves as a constant inducement to other countries—with chronic surpluses—to seek this same right. If they attained their objective, the power would, in my opinion, be used to the detriment of the national interests of the United States and the rest of the world. Keynes also was concerned about the possible abuse of the veto power. His proposed International Clearing Union would have precluded a "preponderant power of veto or enforcement lying with any country or group."

Most of the member countries of the IMF would tend to support such a move by the United States. Even an about-face by the EEC would not be impossible, as it would actually represent a move toward equalizing their formal power with that of the United States. Regardless of what the EEC might do, however, if the United States attempted this action, it would serve as a valuable precedent. Even if it should fail because of EEC opposition, the record would have been set straight on this country's position regarding future attempts to proliferate the veto. The United States would have made a worthy gesture towards international monetary cooperation.

As a practical matter, a failure to ratify the proposed SDR facility would have no real effect on the actual creation of international liquidity for a matter of years. (Ratification would probably produce no liquidity for another two years at least, and when it finally did produce SDR's, the amounts would be minuscule.) Even the staunchest advocates of the SDR plan admit that early SDR allocations would be small; and the first would cover a five-year period. In my view, allocations always would either be too small, or else "cost" too much.

One possible repercussion of rejection of the proposed new SDR facility is an undermining of foreign central-bank confidence in the continued free gold convertibility of the dollar at the \$35.00 price. There might also be disturbance in the private gold markets, with attendant uneasiness spreading to the currency exchanges. To deal satisfactorily with such an eventuality, a further change in the international monetary system is required—a more fundamental change in the link between the dollar and gold than was accomplished on March 17, 1968. The change, which is now to be considered, would constitute the final element in a comprehensive program of orderly international monetary reform.

Changing the Link to Gold

The balance-of-payments strategy of the United States rules out devaluation of the dollar, in view of a moral commitment to countries that have kept faith with the United States by continuing to maintain their reserves in dollars, and the fact that the big gainers from devaluation would be the gold hoarders. Accordingly, the long-term American objective has been to achieve a greater degree of domestic price and economic stability than the major surplus countries, so that, over time, the current-account surplus can improve, along with a strengthening of the international competitive position of the United States.

Aside from the Vietnam situation and other factors, such as the attainment of full employment, that have checked the effectiveness of this strategy, even if the United States were able to achieve a record of price stability second to none, this could not stop the drain from the monetary gold stocks of the United States. In a world generally characterized by a downward rigidity of prices and wages, a continuing upward drift of the level of prices and wages must be anticipated. With the fixed \$35.00 official price for gold and rising gold prices on the private market, pressures will mount for the conversion of dollars held by central banks into U.S. Treasury gold. The private demand for gold for industrial and other uses continues to accelerate, reflecting new exotic industrial uses for gold, the rising incomes of private individuals, and speculation on the prospects for a substantial increase in the official price of gold. (The continuing disappearance of monetary gold into private stocks had become a matter of serious concern even before the added disturbance caused by the sterling devaluation of November 18, 1967. A projection of available figures based on the fixed \$35.00 price indicates that, by 1979, in the United States the private sector alone would consume *more* than the entire gold production of the Free World. Taking into account the rest of the world's consumption needs, the drain of monetary gold into private markets at the \$35.00 price would have become irreversible long before 1979.)

An end of the Vietnam conflict would not solve this problem. (One unacceptable way to solve it would be a massive worldwide depression; this could alter the relative price situation to the point where gold was no longer a bargain even at the official \$35.00 price.) In addition, the United States will not eliminate its payments deficits if others do not eliminate their surpluses. The United States payments deficit is, and always has been, small relative to the size of its enormous economy. Indeed, its size *per se* tells us little; it is attitude that counts. This holds so long as the dollar continues in the role of the world's most important international monetary medium.

Under the present international monetary system, governments seem willing to accumulate gold virtually in unlimited (undefined) amounts. When they accumulate large gold reserves, they become inclined to adopt increasingly appropriate adjustment policies. A similar accumulation of some other form of international monetary asset (say, claims on the IMF, or dollars) would more likely produce loud complaints than appropriate adjustment policies. This fact—that no other international monetary asset is as acceptable as gold—is implied by the limitations countries insist on imposing on their commitment to accept additional SDR's (namely, no more than twice their original SDR allocation). The same is true of the Bretton Woods system's implicit limitation: quota represents the limit to which countries are prepared to accept claims on the IMF (in lieu of owned reserves).

In the absence of world government, there is no other type of financial asset that receives international monetary acceptance fully equal to that of gold. Indeed, this characteristic is enhanced when gold is artificially underpriced (for official international settlements). Gold is the only international money that bears no one's "I.O.U." It is generally accepted without concern about whom or what it is financing. This does not mean that its international monetary role might not be destroyed. Major governments could, if they wished, destroy the monetary role of gold by proclaiming an end of its acceptability in monetary settlement. Indeed, circumstances are conceivable under which such a step might be deemed necessary. But in a world of nation-states, there is nothing that could fully replace gold as international money.

It is appropriate, therefore, to consider international monetary reform in terms of *supplementing* gold as an international reserve asset, not *supplanting* it: we cannot really create "paper gold." The international monetary structure, as set out in the IMF Articles of Agreement, was designed to operate with gold: gold is mentioned explicitly in ten of the twenty IMF Articles of Agreement, and in three of the five schedules appended to the Articles. Thus, destroying the monetary role of gold would, under present circumstances, be revolution, not orderly reform.

To halt the threat of a continuing drain on its monetary gold stocks, the United States should change the status of the dollar from that of free gold convertibility in international settlements to "current-account convertibility." (The term is misleading. It refers to a legal status, not to any necessary distinction between current and capital transactions. A more comprehensive analysis of the current-account dollar is presented in my earlier essay in this series, *Changing the United States Commitment to Gold*, November 1967.) Under this status, convertibility of the dollar would be established through official intervention to maintain fixed rates of exchange for foreign currencies (within permissible mar-

gins) in the private markets within United States territories. This is the status of *all* other currencies defined as convertible under the IMF Articles. Thus, the United States might thenceforth convert dollars presented by a central bank in international settlement into the country's own currency, rather than, as now, only into gold. Where would the United States get the currencies? It would purchase them *for dollars* from the Fund, up to one tranche a year. More currency, as required, could be purchased from the Fund for gold. Where would the Fund get the currency? From its own holdings. If these were low, it generally would *borrow* the currency; in view of IMF-member obligations, the Fund should not purchase currency for gold unless satisfied that the policies of the (surplus) country are not responsible for the currency scarcity. (A borrowing might sometimes be combined with a purchase for gold.) If a country rejected a Fund request to borrow its currency, the currency could be declared scarce. Other IMF members could then legally discriminate against purchases by their nationals of the goods and services of the offending country.

The current-account dollar would better seal off the monetary gold stock of the United States from possible disturbances due to higher prices on the private gold markets. However, the survival of the system under a two-tier arrangement could ultimately require more fundamental action. Looking ahead to the contingency that the private price of gold climbs to uncomfortable heights, the Fund should begin *now* to consider ways in which the official price of gold might be raised without creating inequitable effects. One possibility, for example, would be to reallocate a major part of the revaluation profit among all IMF members in proportion to their quotas in the Fund—thus “permanently” insulating the monetary role of gold from the forces of private supply and demand.

Concluding Remarks

Changing the status of the dollar from gold to current-account convertibility and returning to the principles to which the architects of Bretton Woods adhered offers the best hope for a rational and orderly reform of the international monetary system. A truly effective reform of the system would provide for better balance in the international monetary-power structure. The SDR scheme fails in this major respect. It is mainly because of this failure that its adoption would not, in reality, produce adequate amounts of international liquidity. Indeed, its adoption would heighten the difficulties of achieving meaningful reform in the future.

A genuine reform of the international monetary system would provide a major opportunity for reversing the dangerous trend toward increasing protectionism and discrimination. This trend was set into

motion by the unsuccessful efforts of the United States to eliminate its balance-of-payments deficits, as European surpluses also have persisted. The tying of foreign aid, the mandatory controls on direct foreign investment, the "interest-equalization tax" on portfolio investments, the "voluntary" controls over the international transactions of commercial banks and other financial institutions, and the contemplated restriction of foreign travel, tariff surcharges, or "border-tax" adjustments—all of these neo-mercantilist devices are symptomatic of the improper functioning of the international monetary system. It is not necessary to make radical changes in the IMF Articles of Agreement to supplement the mechanism already authorized with new and elaborate machinery. Nor is the problem one of "forcing" countries in chronic payments surplus to hold "excess" reserve-currency balances that they do not want. Rather the task is that of recapturing and implementing the balanced mechanism for sharing the burden and generating liquidity created at Bretton Woods.

No international monetary system can function properly unless the enormous United States economy—accounting for some 44 per cent of the economy of the entire Free World—also performs satisfactorily. But, while internal economic stability in the United States is a necessary condition for the proper functioning of the monetary system, it alone is not sufficient to achieve that end. From 1957 through 1964, it will be recalled, there was unprecedented price stability in the United States. Yet, it was in 1959 that the United States first set out on its present course of ever-increasing balance-of-payments restriction and control. The Europeans were then strongly insisting that the United States pursue tougher deflationary policies. The fact that its unemployment levels were already unacceptably high did not alter the situation. The Europeans were, and they remain, in chronic payments surplus. They have recorded a single message for the United States. Their prescription consists of deflation, retrenchment, and restriction. We shall hear this same message even after Vietnam.

Under its present unilateral commitment, the United States determines what the official price and role of gold shall be in the international monetary system. By shifting to a current-account dollar she would share this power and responsibility with the Free World community which centers on the IMF. A major effect of this lessened responsibility would be to avert the risk of a continued drain of gold from the monetary stocks of the United States. In addition, a failure of the U.S. Congress to ratify the SDR scheme—which under present circumstances would grievously disturb the foreign-exchange markets and undermine confidence in continued gold convertibility for international settlements—could be contemplated without major apprehension about the possible

consequences. With a current-account dollar, and implementation of the mechanism for liquidity creation and payments adjustment already authorized by the IMF Articles, the United States would then be in a position to make full use of the facilities of the Fund. Accordingly, it could announce the scheduled dismantlement of the balance-of-payments controls it has introduced since 1959. Indeed, a pledge to dismantle these neo-mercantilist restrictions would rally domestic and international support for the reforms recommended in this essay.

With a change to the balanced international monetary system contemplated in its charter, the Fund would need to reform its *modus vivendi*. For example, the special compensatory facility for the less developed countries would no longer be needed: they, like the rest of the Fund members, would instead receive the far more powerful support of the inspired system created at Bretton Woods. The Fund would need to strive for evenhanded objectivity: no more double counting of gold. The Fund must not become an open door to unlimited financing of countries in chronic payments deficit, nor an open conduit for the transfer of gold to the reserve hoarders. Only in exceptional circumstances—and provided the Fund is satisfied with the economic policies of a particular country—should it consider a possible waiver of its 200 per cent (or other) limitation on a member's drawing rights, or a use of its gold to purchase, rather than to borrow, the additional currency needed because of a shortage. Its charter sets out the principles for the Fund's operations and the obligations that nations undertake when they become signatories to the Articles of Agreement.

To attain a properly functioning international monetary order, there must be relative economic stability in the United States and reform of the presently unbalanced international monetary system. The failure to achieve either of these objectives can only lead to the further gross neglect of urgent human needs, the proliferation of mercantilist controls, even greater erosion of American traditions of individual liberty, and, eventually, even the threat of major world depression and collapse of all semblance of international monetary order. Selective restraints have never succeeded in resolving fundamental balance-of-payments difficulties. Other countries have tried them in the past, and they will not succeed in this instance. The longer the restrictionist path is followed to reach an end it cannot attain, the further will restraints proliferate, and the more inequitably will they be enforced. Only by resolute action can the present tide of events be reversed.

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