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TOWARDS NEW MONETARY RELATIONSHIPS

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PETER B. KENEN, *Director*
International Finance Section

Re. *Towards New Monetary Relationships*, by Rinaldo Ossola,
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ERRATUM

On page 17, the quotation just before the subheading should read: ". . . the best alternative to a system of fixed rates with provision for increasing liquidity would, in our view, be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc. There would be relatively fixed rates within each bloc and flexible rates between them. Adoption of this system would imply cutting the tie between gold and the dollar." (*The U.S. Balance of Payments in 1968*, p. 259).

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TOWARDS NEW MONETARY RELATIONSHIPS

This essay tries to explore the possible impact that certain decisions (some taken in the course of the last few years, others likely to be taken in the not too distant future) may have on the evolution of the international monetary system. It gives special attention to the monetary relations between the United States and an enlarged European Economic Community (EEC), and between these and the emerging countries. An attempt has been made to express these issues in the framework of the established order of the International Monetary Fund (IMF).

The international monetary system, as it works today, can truly be said to be centered on the IMF. It is characterized by the following essential elements: (1) complete nondiscriminatory freedom of current payments and transactions; (2) the discretionary power to control capital movements provided the freedom of current payments and transactions is not prejudiced (member countries have less and less availed themselves of this power, especially after 1958, when external convertibility was reestablished by most of the industrial countries); (3) stable parities, fixed in terms of gold at realistic levels and in agreement with the IMF; (4) par values, which in case of fundamental disequilibria can be adjusted after consultation with the Fund and, normally, after the Fund's concurrence; (5) fluctuation of exchange rates which for spot transactions can vary within 1 per cent on either side of the par value—a limit which may be exceeded, but only to a reasonable extent, for forward transactions.

In general, the currencies of all Fund members have been put on an equal footing. The U.S. dollar, however, has obtained a special status as the result of various factors which have led to its establishment as the main currency in which international trade is transacted, in which international reserves are held, and which central banks employ when intervening in the foreign-exchange markets to stabilize their own currencies. The IMF requirement that currencies not deviate by more than 1 per cent from their official par values in terms of gold or, in practice, the dollar has the logical result that related currencies, such as those of the EEC countries, can diverge from one another by as much as 2 per cent (when, for example, currency A appreciates by 1 per cent relative to the dollar while currency B depreciates by 1 per cent relative to the dollar).

Therefore, it is technically possible under the IMF rules for the "fixed" exchange rate between two EEC countries to change by up to 4 per cent (as currencies A and B exchange their positions at the limits of the narrow band around their dollar par values).

However, all the EEC countries and almost all the OECD (Organization for Economic Cooperation and Development) countries keep their margins of fluctuation vis-à-vis the dollar within 0.75 per cent. Consequently, the exchange rate between two EEC countries can change up to 3 per cent, that is, intra-EEC exchange-rate fluctuations can be twice as large as those vis-à-vis the dollar. Moreover, parity regulations among the EEC countries are stricter than those of the Fund. According to the Rome Treaty, each country must consider its own exchange-rate policy as a matter of common interest and, according to a decision taken in 1964, prior consultation among member countries is required if a country wishes to change its par value. (Consultations under these agreements took place in August and October 1969 on the occasions of the devaluation of the French franc and the revaluation of the Deutschemark.)

The above has special significance, in view of the fact that historical experience shows that the development of a common-trade area inevitably leads to a common-currency area. Vagaries of exchange-rate differentials affect price differentials, leading to competitive advantage and disadvantage related not to market or quality conditions, but to differences in monetary values beyond the producer's or trader's control. The history of the United States, which may be said to have been an antecedent of today's common-trade areas and integrated markets, shows how pressure from economic forces eventually leads to monetary unity. Even though the various parts of the United States were all joined through the gold dollar as the common currency, up to the time of the Civil War, there were wide differences in the costs of transfer of funds—either because notes issued by state banks circulated at varying values, depending on prestige or risks, or because the time element in the shipment of funds led to considerable escalation of interest rates between the financial centers and the rest of the country. A major factor in the introduction of a "national" banking system a century ago was a recognized necessity of introducing a uniform currency that would command acceptance and prestige and maintain a single par value throughout the nation. This, however, still did not alleviate the differential cost of shifting banking funds (through drafts or checks) subject to commissions and of changes related to the time element involved in their transfer. For this reason the Federal Reserve was charged, from its establishment, with the task of providing "exchange at par" for banking trans-

fers throughout the nation. The experience of the United States would seem to show that exchange-rate differentials, small as they may be as a marginal price factor, have a larger impact on business profits, which is sufficient to bring pressure for their elimination in order to strengthen economic ties through greater efficiency and lower cost in the movement of financial and real resources.

EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

The International Monetary Fund has a significant influence on the monetary relations among its 117 member countries (almost the entire international community with the exclusion of most socialist countries). The Fund has indeed been able to shape its objectives in accordance with the changing demands of the last 25 years and today it is undoubtedly an instrument fully capable of coping with the significant developments that are in the making. Actually, since Bretton Woods, the international monetary system has been integrated with new instruments which are either directly linked with the Fund or make the Fund more effective by supplementing the temporary assistance it provides to countries in balance-of-payments difficulties. Here are some examples: (1) the General Agreement to Borrow, whereby the major industrial countries have extended to the Fund credit facilities amounting to 6 billion dollars, thus relieving pressure on the Fund's own resources; (2) reciprocal monetary arrangements for lines of credit ("swaps") between the Federal Reserve Bank of New York and the central banks of the major countries, which now amount to well over 11 billion dollars; (3) the establishment, in case of need, of regional credit facilities for the defense of important currencies other than the dollar; (4) short-term-credit arrangements among the EEC central banks for a total amount of 2 billion dollars; and (5) the Fund's compensatory financing and buffer-stock arrangements for the needs of the emerging countries. If one adds all these facilities to the Fund quotas, now increased to over 28 billion dollars (or over 10 per cent of the annual exports of all countries), it is possible to judge the strength of the defenses which protect the system against temporary excess of countries' payments for imports over earnings from exports, and from all but the worst speculative movements of money between countries.

While these enlargements of sources for supplementing countries' holdings of foreign-exchange reserves are important, they have not been considered sufficient. Other measures have been taken, or are under consideration, which will provide further evolutionary impulses to the system. The changes include:

(1) the creation and subsequent activation of Special Drawing Rights

(SDRs), whereby the principle has been introduced that the reserve assets needed to cope with the long-term need for unconditional international liquidity must be created by deliberate action and in a non-inflationary way, rather than as a result of gold mining or of payments deficits of the United States;

(2) the Washington Agreement of March 1968, which sanctioned the separation between monetary gold and gold as a commodity, as well as the December 1969 agreement between the IMF and South Africa, which, although it reduced the degree of separation, established that newly-mined gold will enter into official reserve holdings on the basis of Fund decisions;

(3) a development that may have a great significance is the decision taken on December 1969 at The Hague by the Community heads of state and of government aiming at creating within the next ten years an Economic and Monetary Union. (Negotiations for admission into the EEC of the United Kingdom and of other candidate countries have been resumed in recent months, after the fruitless efforts of 1964. These now have much better chances of success as a result of both a softening of certain national positions within the EEC and a more decisive political will on the part of the applicant countries.);

(4) of major significance for the mechanisms of international trade, the proposals aimed at introducing into the international monetary system a moderate degree of exchange-rate flexibility, as indicated in the September 1970 Report of the Executive Directors of the Fund.

These are the most meaningful innovations that can deeply transform international monetary relations, albeit with the gradualism necessitated by political considerations, especially when the transformations imply the transfer of powers and responsibilities from the national to the supranational sphere. The International Monetary Fund will continue to be the indispensable moving force in this evolutionary process; its relations with individual countries will gradually be replaced by relations with groups of countries, free-trade areas, and economic communities—that is, with monetary areas wider than the present boundaries of a state.

Further evolutionary impulses to the system will also come from the following developments: the increasing interdependence of national economies stemming, *inter alia*, from the acceleration of technological progress and from the numerous transnational mergers of major corporations and banks; the increasing influence that economic policy decisions taken by one country, especially if it is a major one, exercise on other countries; the accelerating expansion of the Eurodollar market where important internal multiplier effects are becoming increasingly evident. These developments, combined with the continuous rise in

private-sector financial assets, have greatly increased the interest sensitivity of capital, further complicating the adjustment process.

FUTURE ROLE OF SDRS

When considering innovations, one should begin with the Washington Agreement of March 1968 and the creation of SDRs. These two events have set in motion an irreversible process whereby the monetary system departs from the "gold-exchange standard" by gradually reducing—and eventually eliminating—the monetary function of gold in the system and tending to diminish the reserve role of the dollar.

During the last decade the share of gold in total reserves has continuously decreased, since almost all newly-mined gold has been used to meet industrial needs and other demands. Accordingly, monetary authorities have tended to use less and less gold, with external disequilibria being financed mostly by selling foreign exchange, activating swap arrangements, and utilizing Fund Reserve Positions and Fund credit facilities. Gold has been sold only as a last resort—a somewhat paradoxical end for what has traditionally been considered the most liquid reserve asset.

To the extent that SDRs gradually become the main source of liquidity for the system, as well as the largest reserve component (such a situation should materialize within 10 to 15 years, if SDRs continue to be created at the present rate), and to the extent that prices continue to increase, monetary gold will decrease in relation to goods and services. This contraction should not be compensated for by increasing the official price of the metal, but by creating SDRs in the amounts needed for international trade and transactions.

In the longer run, as industrial uses inevitably grow, equilibrium between the demand for and supply of nonmonetary gold could thus command increasingly higher market prices, up to the point where the difference from the official price would induce amendment of the Washington Agreement, allowing monetary authorities to finance balance-of-payments deficits by selling gold directly on private markets. The anticipation of such profits on sales of gold might seem to be an inducement to central banks to hold on to their gold stocks or to acquire more gold on the free market. However, the expectation of an increase in the long-term price of gold on the private market may not lead to such behavior, because the expected earnings from the interest income obtainable from foreign-exchange holdings or SDRs may be higher. In other words, if SDRs continue to be a valid instrument, the monetary system will have truly been endowed with a superior substitute for gold.

The experience of the facility's first year is very encouraging. Under

Fund surveillance the great majority of members that have utilized SDRs have done so in an appropriate and prudent way. For the evolution towards reliance on SDRs as the expanding reserve component to take place—which I believe would be highly desirable—it is necessary that the monetary authorities continue to have faith in the validity of this new instrument. Especially, they must trust that SDRs will meet the global, long-term need for international liquidity in a rational manner, that is, independently from events such as gold production and balance-of-payments deficits which have little or nothing in common with these needs. Unlike gold and dollars, the creation of SDRs is under international control, and international liquidity can be increased without resorting to destabilizing changes in the price of the reserve instrument. Furthermore, SDRs are the only instrument whose production does not absorb real resources. One must point out, however, that among European monetary authorities the conviction is spreading that there should not be a second activation of SDRs in the near future (or, at least, any such activation should be very small, not to say symbolic). This conviction stems from the considerable increase which has taken place in official dollar reserves during 1970, an increase which is moreover considered likely to continue in 1971.

These are of course complex issues, which those who determine the amount of new SDRs will have to face. One question is whether the need for international liquidity should be measured on the basis of net rather than gross reserves. For example, an increase in reserves in the form of official holdings of dollars has its counterpart in a deterioration of the American liquidity position. (Holdings of SDRs, gold, and so forth, by the United States may be unchanged, but its liabilities to other governments in the form of dollars—liabilities which it may be obliged to pay off with gold or SDRs—may have increased.) Even if gross reserve assets should be the correct concept, a grant of SDRs would not necessarily raise gross reserves of the United States; instead, it might induce reluctant holders of dollars to oblige the United States to use up some of its newly-allocated SDRs to buy up some of those undesired dollars.

The preceding discussion has assumed that SDRs will succeed in establishing themselves as a major component of international reserves. It was indicated above that there is some opposition to this belief. However, the success of the anti-SDR thesis, which could be facilitated by the persistence of large American deficits, would indeed be a calamity. Paradoxically, for a time it would even cause the establishment of a dollar standard, because central banks would be forced to accept the surplus dollars offered by the United States in payment of her deficits.

In that eventuality, two hypotheses are possible. The first is that gold would again become, although only temporarily, the basis of the system; and for gold to serve this purpose its price would have to be raised. However, because gold does not yield interest, reserves would very soon tend to be converted back into a credit asset—most probably dollars. We would then have come full circle, and there is general agreement that it is always better to run straight than in the best of circles. It is not difficult to forecast that in such circumstances recurring crises would affect the major currencies.

The second hypothesis is that gold sales might be suspended by the U.S. Treasury, owing to massive conversions by foreign monetary authorities. The consensus is that, if the United States were to take such a step towards a *de facto*, if not indeed a *de jure*, dollar standard before the European countries had made substantial progress on the road to monetary union, it would almost certainly induce conflicting reactions among the EEC countries. This would set in motion a process of disintegration within the Community, which would soon require the imposition of severe exchange controls. A long period of monetary disorder, similar to that which characterized the twenties and the thirties, would thus begin.

For these reasons, one must hope that the anti-SDR thesis will not succeed, although one cannot exclude the possibility. Even in the early stages, the smooth continuation of the SDR system, especially if holders of this asset were to be rewarded with an interest rate higher than the present 1½ per cent, would have the advantage of increasing the desirability of this asset. While this would mean that the role of the dollar as a reserve currency would be progressively reduced, it would also imply that the dollar could keep the function of an intervention currency (possibly together with the other intervention currency that might emerge from the European Economic and Monetary Union) and would increase its role as a vehicle currency.

ECONOMIC COOPERATION WITHIN EUROPE

Economic and Monetary Union

The second order of events liable to affect deeply the structure of international monetary relations in the near future is represented by The Hague decisions of 1969, the Werner Plan and the EEC Commission proposals, in addition to the beginning of the negotiations for the admission of the United Kingdom into a rapidly changing Community.

The final objectives of the Economic and Monetary Union can be briefly summarized as follows: free movement of labor, trade, services

and capital so that economic objectives can be pursued on the EEC scale rather than at narrower national levels; full, irreversible currency convertibility; elimination of intra-EEC margins of fluctuation; irrevocable fixing of intra-EEC par values in order to reach the *de facto*, if not the *de jure*, creation of a single currency to be jointly managed by the Community central-bank system; transfer from the national states to the Community of responsibility over economic matters such as the state budget and the budget of the rest of the public sector, internal liquidity, credit policies, the capital market, external monetary policy, and regional and structural policies. The transfer of economic responsibilities from the states to the Community presupposes that the center of decision-making (which is likely to be the Ministerial Council at first, and the Commission later) will be politically responsible to a democratically elected European Parliament. A refusal to make such political choices by considering them utopian may lead to an even more dangerous utopianism, namely, that Europe can be built by means of a few clever technical schemes. Saying that one should begin directly with the first phase of the work without worrying about the institutional problems and political decisions involved is as realistic as beginning a long and costly trip without knowing the destination.

The first phase of the realization of the Union should begin as soon as the EEC Ministerial Council takes a decision on the Commission's proposals. The first meeting took place in mid-December 1970 and the second one was held in early February of this year; the views which were exchanged among the EEC financial ministers and central-bank governors in connection with the recent Arnhem meeting give rise to some optimism about the final outcome of the negotiations.

The first phase will last three years and will cover events of great moment, such as:

(1) reduction of fiscal barriers within the Community (lessening of differences in tax rates and of the rates of value added and excise taxes, harmonization of tax rates and the tax base applicable for fixed-income financial assets and dividends, harmonization of corporate taxes, complete lifting of controls on intracommunity travel);

(2) free circulation of capital within the Community (introduction and gradual increases in the maximum sizes of bond and stock issues that private and public enterprises of one EEC country can make in another EEC country, quotation on the stock exchange in one or more EEC countries of stocks and bonds issued in another EEC country, abolition of residual exchange controls within the Community);

(3) strengthening of the coordination of short-term economic policies,

especially budget policy in the framework of guidelines set out for medium-term economic policy;

(4) progressive adoption of common positions in economic relations with countries outside the Community and with international organizations. In particular, as a rule members should not avail themselves individually of any greater flexibility of exchange rates that might be introduced into the international monetary system;

(5) during the first phase, members should accept a small and experimental reduction of the fluctuation margins of their currencies, that is, intra-EEC margins should be narrower than those resulting from the application of margins stipulated vis-à-vis the U.S. dollar.

As regards the latter point, it would be very advantageous, at least during the first phase, to have a widening of the margins of variation in the rate of exchange established with the intervention currency (the dollar)—for example, from the present ± 0.75 per cent to the full 1 per cent permitted by the present Fund Articles. This widening of exchange-rate variability vis-à-vis nonmembers of the EEC would accompany a reduction of the intracommunity margins (for example, from the present ± 1½ per cent to ± 1 per cent). On the one hand, this would also contribute to the objective of further differentiating the Community system of exchange rates vis-à-vis the dollar, a clear reversal of the present relationship of the EEC currencies to the dollar. On the other hand, it would have the merit of still allowing the monetary authorities of the EEC a margin for maneuver, which recent events have indicated might be quite useful.

Success in meeting this double requirement—each member currency being permitted to diverge from its par with the dollar by no more than 1 per cent but also being limited to a divergence of no more than 1 per cent from its par exchange rate with any other member currency—will require closer intra-EEC cooperation. In practice, the daily management of members' dollar exchange rates would be coordinated by central banks defining the so-called "Community level" of the dollar. The price of the dollar in each of the markets of the Community would not be allowed to deviate from this level by more than a percentage equivalent to half the width of the fluctuations allowed for the Community currencies. The band between the upper margin and the lower margin would fluctuate between the absolute limits applicable to the dollar according to the fixing of the "Community level." Thus, if the EEC decided on an average of ½ per cent appreciation above dollar par values, a member country would be permitted to fix its dollar rate anywhere between the par level itself and a level that was appreciated 1 per cent above par.

One should not minimize the difficulties that might arise in obtaining

agreement among central banks for fixing the Community level of the dollar any time one Community currency became strong while another became weak. If this case should concern two important countries, there might be a conflict over both the size and the direction of change.

Finally, the possibility must not be excluded that, during the period of construction of the Economic and Monetary Union, exchange controls for capital movements might be temporarily necessary at the Community borders. This would perhaps make it easier to secure the entry of applicant countries on terms acceptable to the present members. Moreover, by reducing the problem of destabilizing capital movements to and from nonmember countries, such exchange controls would permit member countries to concentrate their efforts on the liberalization of capital movements within the Community area.

The first phase should last three years (1971-73). No precise schedule has been arranged for the other phases, which are to be completed within the decade, because it was felt that a certain flexibility, based on the experience acquired as this goal is approached, will be needed. In this connection, one should underscore the agreement among members that progress in monetary integration must depend on parallel progress first in harmonizing and later in unifying economic policies. However, it must be clearly understood that, sometime during the formation of the union, a "qualitative jump" will be necessary to pass from the phase of coordination to that of unification of economic policies. This will be possible only if present political relationships are modified. Until that time, the freedom of member countries to make individual par-value adjustments should be protected. In particular, as far as par values are concerned, the process of unification described above should go through a certain number of stages which may be briefly summarized as follows:

(1) Initially, there would be freedom to change par values within the present institutional framework—and this freedom is already qualified by the need for consultations provided for under current Community decisions. These could eventually be strengthened further.

(2) Later, variations in par values would be conditional upon Community decisions to be taken by a special majority. (This stage could begin only following a substantial transfer of authority in matters of economic policy-making from the national level to the Community level.)

(3) Finally, the possibility of changing par values vis-à-vis other members would be eliminated.

European Reserve Fund

At this point, some brief comments are in order about the objectives, structure, and operations of the European Reserve Fund, the creation of

which was decided at the 1969 meeting at The Hague. Currently there are many uncertainties about the objectives such an institution should pursue. Although the targets have been described in recent Community documents in different ways, the European Reserve Fund should be considered as the forerunner of a Community system of central banks (something like the Federal Reserve Board of the United States) to which the following functions could be entrusted:

(1) Until substantial progress in constructing the Union has been made, this Reserve Fund should administer the system of short-term monetary cooperation which was agreed upon by EEC countries in February 1970; it should facilitate the intervention of national monetary authorities in foreign-exchange markets, and aid in the formation of a common reserve policy. At the end of the process, when a single EEC balance of payments would be meaningful, all EEC foreign-exchange reserves would be entrusted to the European Fund.

(2) Once the process of unification has progressed sufficiently, the Reserve Fund should administer the reciprocal monetary agreements between the EEC countries and the Federal Reserve. Above all, it should create a European unit of account (EEC unit) which could be utilized by nonmember countries for pegging their own currencies or for acquiring the currencies needed for their interventions in the foreign-exchange markets, and, eventually, as a reserve currency. Regarding the latter, it should in fact be assumed that many outside countries, in the face of the formation of an integrated economic area that would be their main trade partner, would be induced to link their own currencies to that of the European monetary area. Other countries might desire to hold EEC units of account for the sole purpose of diversifying their reserves. The gradual centralization of reserves, as well as the formation of a European unit of account, could begin by having each member country deposit with the European Fund a portion of its reserves (gold, SDRs, dollars). It would receive in exchange an equivalent amount of EEC units, which could be used in transactions with outside countries to whatever extent the latter were willing to accept.

In due time, the resources of this Reserve Fund could be increased if the monetary authorities of countries not members of the Community exchanged their gold and foreign currencies (including the EEC currencies) for EEC units. Its resources could also be enlarged by the gradual increase of the amounts of national reserves deposited with the Fund by the member countries, and its size might later be expanded by issuing EEC units against those sterling balances which the authorities of the sterling area might desire to convert into other assets. In the transitory period leading to the establishment of a single currency, the European

Reserve Fund could utilize its gold and foreign exchange to make short-term loans to member countries, thus assuming a function presently entrusted to the short-term support system of the EEC.

The European Reserve Fund would evolve gradually into an EEC system of central banks which, as far as decisions on internal monetary policy are concerned, would be responsible for the money supply, interest rates, and decisions on lending to public and private sectors. The system would also be responsible for intervening in foreign-exchange markets and for managing the reserves of the Community.

Step by step, the European units of reserve issued by the Reserve Fund, through interventions effected in foreign-exchange markets, would also be held by commercial banks, a process which could be facilitated by the monetary authorities offering a money-market asset in which to invest at remunerative rates. Consequently, through an evolutionary process different from the one that led to the dollar and the pound playing the role of intervention currencies, a new intervention currency would emerge. At first, it would have an intermediate character between SDRs held only by monetary authorities and the dollar (held by monetary authorities, commercial banks, and private holders). The new instrument would circulate, at least in the beginning, only among monetary authorities and commercial banks. In the final stage, the EEC units would become the EEC common currency and would end up being exchanged between businesses and individuals, replacing national currencies.

This process of formation of an intervention currency might be considered unnatural insofar as it does not follow the traditional route, namely, of being first used by commercial operators, and held by commercial banks before being included in the reserves of central banks. In this connection, however, one should not forget that the process of SDR formation was at first also considered unnatural. It was said, with irony, that this was a reserve created out of nothing, brought to life by a magic wand, made out of thin air. Yet it seems to have already come into its own.

Thus, on the whole, there is no reason why there should be only one currency as "reserve" and "carrier" instrument. On the contrary, alternate international currencies have been the rule rather than the exception in economic history. There were for many centuries gold and silver, and the elimination of silver still brought pressure for its remonetization as a supplement to gold as the latter grew relatively scarce well into the twentieth century. The ending of silver as the partner of gold gave way to another alliance of gold and sterling, with their interchangeability made possible through the London market and the Bank of England. From the First World War through the fifties both the United States

and the United Kingdom shared in supplying the rest of the world with reserve and intervention currencies—the dollar and sterling. In this interwar and immediate postwar period, other countries could relate themselves to either one or the other of these two leading countries and currencies, or both, depending on the relative advantage of one or the other in terms of their needs in commerce and their access to credit and capital markets. Many countries remained tied to sterling long after it had lost its "key-currency" position, because of the ready availability of financing from the London market, confirming the lasting usefulness of a currency that has gained an accepted position and role in the world's economy.

It goes without saying that the coexistence of two currencies meeting reserve and intervention needs would require continuing and mutual cooperation. These currencies would be interdependent and interconvertible, since it would be assumed that the Common Market would continue to hold and add to its dollar reserves and the United States would correspondingly acquire and add European monetary units to its reserves. This process has been, in fact, going on since the early sixties, when the Federal Reserve began to hold larger net positions in foreign currencies. In the light of relations between the United States and the United Kingdom, when sterling and dollars shared the reserve and intervention function for third countries, this coexistence of alternative currencies provided an option for many countries, whether in the Western Hemisphere or in the Commonwealth, to acquire and hold either dollars or sterling. There should not be any reason why such a twin-currency arrangement should work less smoothly between the Common Market and the United States than it did between the United Kingdom and the United States. On the contrary, the growth of economic strength of the Common Market, including the United Kingdom, the larger role of trade and investment flow between the two areas, and close political ties should all be expected to strengthen present relations and facilitate monetary and financial adjustment, as it becomes necessary in the course of events.

ENTRY OF THE UNITED KINGDOM INTO THE EEC

It is beyond the scope of this paper to examine the monetary and financial problems that arise in connection with the entry of the United Kingdom into the Community, problems deriving especially from the commercial and financial relations which link the United Kingdom to other areas.

Upon the United Kingdom becoming part of the Community, the pound's margins for exchange-rate fluctuations around par should be equal to those of the other EEC currencies. As far as changes in par values are concerned, during the transitional period, the United King-

dom should have equal rights and responsibilities with all the other EEC members, until the day when intra-EEC parities are irrevocably fixed.

A problem which is very important from the point of view of future international monetary relations is that of the fate of sterling liabilities. The Basle agreement of September 1968 will probably be renewed this year, hopefully with the understanding that British arrangements with sterling-area countries will contain a limitation of the dollar guarantee to a ceiling expressed in absolute figures and/or a reduction of their interest rate to the level of the U.S. Treasury Bill rate. The agreement has without doubt been an efficient instrument for neutralizing the effects upon Britain's reserves of the fluctuations of sterling holdings of countries belonging to the area. After the expiration of this agreement and the consequent lapsing of the exchange guarantee covering them, sterling assets officially and privately held by sterling-area countries could be transformed, under agreed terms, either into a world asset—for example, a special issue of SDRs—or a Community asset, through conversion into EEC units. However, sterling balances of official and private holders in countries not belonging to the sterling area should continue to remain a responsibility of the United Kingdom to the issuer country, as is the case of the short-term indebtedness of the other Community members. It should be added that the improvement in the British balance of payments, on one hand, and the constant reduction of the proportions of sterling reserves to total world reserves, on the other hand, allow us to suppose that this type of indebtedness will soon cease to be the distressing problem it has been in the past.

INCREASED FLEXIBILITY OF EXCHANGE RATES

A third order of events susceptible of influencing the evolution of the international monetary system consists of the proposals contained in the 1970 report of the IMF Executive Directors, which aimed at introducing moderate exchange-rate flexibility into the international monetary system. It is not necessary to go into the details of these proposals, which are very well-known. Suffice it to say that, taking them as a whole, their supporters believe them useful for smoothing the process of exchange-rate adjustment. Timely adjustments, and hence the correction of fundamental disequilibria by smaller parity changes than have normally occurred in the past, would replace delayed and massive variations of the exchange parities, often preceded by disruptive conditions. Where no basic changes in parities were needed, temporary flexibility of the exchange rates would allow the impact of capital movements to be absorbed by exchange-rate fluctuation, rather than let it be exerted on reserves and therefore on the volume of internal liquidity. Those who

are opposed to these proposals fear that such innovations will open the way to competitive devaluations and unchecked exchange-rate fluctuations. Within the EEC, it is also feared by some—with small foundation, I believe—that member countries or candidates might avail themselves individually of these innovations, thus seriously jeopardizing the process of Community integration.

A joint position of the Six on this problem will not emerge until after the agreement on the Economic and Monetary Union. Should the Six agree on a moderate degree of flexibility, they would do so subject to two precise conditions: first, that the introduction of a moderate degree of flexibility in the system should take place within the framework of the present Articles of the Fund (in fact, I doubt that at present there exists a majority of the Fund's members in favor of changing the Articles); and, second, that the EEC countries should only avail themselves jointly of the new facilities, especially as regards wider margins—but not before they have reached a sufficient degree of economic cohesion.

All told, such innovations will permit the opening of a new chapter in monetary relations between the United States and Europe in a not too distant future. In the report published in 1963 under the auspices of the Brookings Institution, the opinion was expressed that "the best alternative to a system of fixed rates with provision of increasing liquidity would be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc. There would be relatively fixed rates between them. Adoption of this system would imply cutting the tie between gold and the dollar." (*The U.S. Balance of Payments in 1968*, p. 259).

EMERGENCE OF NEW CURRENCY BLOCS

Much has changed since then. The blocs are shaped differently. A larger provision of liquidity is being arranged, one that seems compatible with a certain increase of exchange-rate flexibility. The latter can or, rather, must coexist with the preservation of a link of the dollar to gold or to some other internationally accepted standard. It remains true that, if Europe is to be capable of making progress on the path of the economic and monetary union, the best arrangement of its external monetary relations could consist in allowing wider fluctuations of the exchange rate between its currency on one side and the dollar on the other and timely adjustments of the par value in case of emerging fundamental disequilibria. It should be noted that as trade with nonmembers of the EEC shrank in relation to the gross national product (because of the formation of the EEC currency area plus the areas which would inevitably gravitate towards the EEC), the inconvenience of even a large

fluctuation of the exchange rate would lessen. The domestic disruption from rate changes would in fact become quite small, for the ratio of extra-bloc trade to GNP would probably shrink to the very low level it has reached in the United States.

In May of 1970 at a conference in Geneva, Robert Roosa, discussing the developments which are likely to occur in international monetary relations, did not exclude the possibility that three monetary centers would join the dollar: an EEC currency, the yen, and a convertible ruble. It is difficult to say how these new areas will develop, but such expectations certainly correspond to the dominant trend of evolution of the system.

The increasing acceptance of the Japanese yen in Southeast Asia will considerably enlarge its function as a vehicle currency, regardless of the fact that the monetary authorities of that country do not wish to see the yen more widely used. The recent formation of an investment bank among the socialist countries, their active participation in the Eurodollar market, their continuing interest in the Bank for International Settlements by its socialist members, and their intermittent interest in the International Monetary Fund would seem to suggest that there is a conviction growing in that part of the world regarding the necessity of bringing themselves closer to the multilateral and flexible financial system of the West.

One should not forget that it is incorrect to pose a dichotomy between industrial and emerging countries. As a matter of fact, the currencies of some countries which are classified as "emerging" are already utilized in Fund drawings; some of them are even fully convertible. In this connection, it should be pointed out that economic unions are in the process of being formed in various parts of the world—for example, in Central America, among many countries of South America, and in East Africa. As in the case of the EEC, this process will lead to monetary integration, and by providing the basis for freer trade will contribute to greater monetary strength within each area vis-à-vis other areas. Undoubtedly, it would be in the common interest of the international community if the more industrialized countries were to encourage and support such a development. Consequently, even at the risk of being accused of crystal-ball gazing, one would hesitate to limit the horizon of future international monetary relations to the four centers mentioned above. Nevertheless, this process may leave out countries which do not find it possible or advisable to participate directly in any common-market arrangement. Such countries would still have the important advantage of being able to choose to link their currencies to one or the other of the existing or emerging blocs.

It is not ruled out that, while inside each area fixed parities with only limited margins for fluctuation would be the rule, wider margins and a reasonable degree of par-value flexibility would prevail in relations between the various areas. Each one of the areas would hold in its reserves gold (as long as the metal continues to be in the system), special drawing rights, IMF Reserve Positions, and a certain amount of the currencies issued by the other areas—to be used for pegging or intervention purposes.

The emergence of monetary unions would eventually lead to the allocation of SDRs directly to such unions rather than to the individual members. This would provide the basis for common reserves and foster the pooling of members' reserves, thereby facilitating the movement toward a common currency in each area. In connection with the developing countries, a portion of the special drawing rights could also be distributed in a different manner from that prescribed by the present Articles of Agreement. Within the creation of SDRs made in accordance with the global needs of international liquidity, some sort of link between SDRs and economic development could be devised which would not necessarily be inflationary. But this particular problem has not yet received sufficient attention and, consequently, the time may not be ripe for a decision in this field.

The United States is presently operating through the Federal Reserve in the money and foreign-exchange markets of other advanced countries by a maze of swap agreements involving 15 central banks (or monetary institutions) and their relative currencies. Its large credit line—of over $11 billion—is fractioned, however, among different currencies, whose availability is in principle restricted to transactions in each local market. These currencies are of different strength and acceptability and their own creditworthiness is also subject to wide and sharp mutations. The interconvertibility of these currencies is also subject to limitations, although it is facilitated by the Bank for International Settlements on a case-by-case basis. It would be a great improvement in the operations of the Federal Reserve to have as a counterpart a single and strong multinational institution, and the dollar a single and widely accepted currency through which it could intervene in any market, at any time, up to any portion of the credit line. Also, the amplitude of market facilities, compensating shifts within the market itself, should lessen the need for local intervention. All this should help in maintaining the relative position of the dollar vis-à-vis other currencies, and therefore reduce the need for the Federal Reserve to intervene. Moreover, as the system stands now, the emerging countries have no real choice in the way they may hold foreign reserves or intervene in foreign markets in support of their own curren-

cies—it is either the dollar or gold. In view of the high cost of carrying gold, the authorities of emerging countries are reduced to operating almost exclusively in dollars. The emerging countries are continuously in the market either to sell or to buy dollars, and their operations may or may not coincide with international monetary stability at the particular time. These destabilizing effects depend on the way their balances of payments move or the rate at which they accumulate or dispose of their dollars. Should the emerging countries have an opportunity to hold surpluses in another common reserve unit, as strong and as acceptable as the dollar, such destabilizing movements would be lessened. Also, the accumulation of reserves in a new unit would facilitate the entry of foreign countries into Eurocurrency markets, for bank borrowing or capital issues, thereby lessening the pressure on American financing.

The financing of short-term capital movements between the areas should be assured by swap arrangements between the monetary authorities of the various areas—for example, as mentioned above, between the Federal Reserve System and the EEC Central Bank System, which would encompass all the agreements which today link the Federal Reserve with the individual central banks of the EEC. Each monetary center would, however, organize a network of swap arrangements with the countries with which they maintain special economic and financial relationships—for example, the United States with Canada and Mexico and the EEC Central Bank System with Austria, Switzerland, and Sweden. Swap arrangements would thus become an even more efficient mechanism for the recycling of short-term capital movements.

With these arrangements the role of the dollar as a reserve asset would gradually diminish in importance, while its role as intervention currency and especially as vehicle currency for commercial and financial transactions would be increased. Moreover, step by step, the dollar would be flanked in those three functions by the new currency units.

CONCLUSION

The analysis of the medium-term perspectives of international monetary relationships leads to two final considerations. The first regards the International Monetary Fund, which will find itself having to deal mainly with those responsible for economic policy in the various monetary areas, rather than with the authorities of individual countries. As in the evolution of central banking in domestic markets, the strengthening of the economic, financial, and monetary structures underlying these relationships will free the IMF from certain minor operations, but will enhance its role and influence in major decisions and actions affecting the stability of the world monetary order. Secondly, these new mone-

tary relations would be consistent with the emergence, and would indeed facilitate the further development, of multinational economic units which give confidence to the maintenance and strengthening of free trade—the foundation of rising economic prosperity and living standards in all nations.

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