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No. 89, September 1971

THE REFORM OF THE
INTERNATIONAL PAYMENTS SYSTEM

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AND
HOSSEIN ASKARI



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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THE REFORM OF THE INTERNATIONAL PAYMENTS SYSTEM

The system of international settlement and liquidity presently in force and centering on the International Monetary Fund has served us, on the whole, rather well for a couple of decades. Under this system, there has been an unprecedented increase in international movement of goods and capital which has, by and large, benefited all participants. Unfortunately, with the passage of time, shortcomings have begun to be apparent in this system and they have become gradually more evident as economic and political crises have succeeded one another with increased frequency and severity. By now there is a general feeling that the system is no longer viable in its present form; yet no alternative design has been proposed that has sufficient economic cogency and political appeal to command the widespread support necessary for its implementation.

Our purpose here is to propose a set of reforms that would retain the major advantage of the present system, to wit the relative stability of exchange rates associated with a system of parities, while eliminating its major drawbacks, such as the need for occasional discontinuous large changes and attendant speculative upheavals, the severe constraint on the ability of countries to pursue independent domestic policies, the lack of an adequate mechanism for creating the "appropriate" amount of international liquidity or even of a criterion for judging what is "appropriate," and the uncertainty as to the desirability of the dollar as an international store of value. In addition, our reform would provide the world with a facility that has never existed before, namely, an international numéraire and store of value having a stable purchasing power. All this would be accomplished through a set of modifications of the present system which are institutionally and economically quite simple, although, no doubt, they presume a strong commitment to work for the common good, at the cost of some compromise.

In the conviction that our reforms are practical, we wish to address ourselves to a wide audience. Accordingly, before presenting our proposal, we devote respectively Sections I and II to a survey of the present system and to a review of its drawbacks and why these have become more acute with the passage of time. Then, in Section III we outline the basic ingredients of our reform, and, finally, in Section IV we analyze the properties and operating characteristics of the reformed system. The

expert, who is thoroughly familiar with the present system and its ills, may wish to proceed directly to Section III.

I. A SURVEY OF THE PRESENT SYSTEM

The present international payments system for countries that are members of the International Monetary Fund can be characterized by the following set of rules and institutions.

1. Reserve Assets and Factors Controlling their Quantities
 - (a) Monetized Gold: fixed in quantity, basically at the historical level determined by the gold reserves of member countries at the time of the adoption of the two-tier system. (That is, the understanding among the monetary authorities of major countries not to buy or sell gold except from one another.)
 - (b) Special Drawing Rights or SDRs ("paper gold"): an intangible asset issued through the International Monetary Fund, having a fixed parity to gold; quantity changeable by a rather complex procedure requiring the agreement of a qualified majority of members.
 - (c) Short-term Claims on the United States held by Foreign Official Holders (basically, Monetary Authorities): changed through payments deficits of the United States and redistribution of the outstanding stock of claims on the United States between official holders and other holders (commercial banks, nonbank public). Such redistribution results, in part, from foreign central-bank policy and, in part, from market forces. *De jure*, the rate of exchange between dollars and gold (and hence SDRs) is fixed by the United States and can be changed by the United States with the approval of the Fund; *de facto*, that parity is unshakable in that the United States is not, at present, willing to entertain the notion of changing it.

2. Permanently Fixed Parities

Each country fixes a "permanent" parity with SDR-gold which determines a permanently fixed parity with every other currency. The parities are subject only to discontinuous changes to a new "permanent" level. In practice, such changes have occurred only when the inappropriateness of the previous parity has become so glaring as to require a major change.

3. Narrow Allowable Bands of Fluctuation around Parity

Each participating country assumes the obligation to contain market fluctuations in exchange rates within a narrow band of parity. This obli-

gation is enforced through each central bank (other than that of the United States) intervening in its country's dollar market to maintain the market price within a band which is, *de jure*, one per cent on either side of parity (hence, of a total width of 2 per cent), but *de facto* has been mostly maintained within $\frac{3}{4}$ of 1 per cent on either side of parity (hence, of a total width of $1\frac{1}{2}$ per cent). The actual market rate of exchange with the dollar establishes all actual cross-rates.

4. *De Jure* Convertibility of Currencies into Gold and SDRs, and Conversely

Each monetary authority has the obligation to buy back its currency from, or to sell it to, other monetary authorities in exchange for gold and SDRs, with some special provisions with respect to the use of SDRs.

5. *De Facto* Semi-Inconvertibility of the Dollar

The United States has, for some time, been using its "power of persuasion" to discourage foreign monetary authorities from exchanging the dollars that they have acquired through interventions in the foreign-exchange market (3 above) for the other two reserve assets. Thus, *de facto, the convertibility of the dollar is limited and uncertain*. This is critical, because, with the obligation to remain within the band enforced by operation on the dollar market only, any country running a reserve surplus initially acquires just dollars. Thus, the United States is the only country that could be asked to exchange its currency for other reserve assets. Other central banks, as it were, are automatically re-acquiring any surplus of their currency flowing out when they support their exchange; and they are re-acquiring it for dollars. (If they run out of dollars, they can acquire more by selling other reserve assets for dollars to the United States or to some other official holder of dollars.)

6. Limitations on the Use of SDRs

When SDRs were introduced, some complex limitations were established on their use. In particular, the average SDR balance of a country over a five-year period may not be less than 30 per cent of its cumulative allotment. This restriction was a concession to the view, held by some countries, that the role of SDRs should be that of a transient reciprocal-credit arrangement.

II. DRAWBACKS OF THE PRESENT SYSTEM

The present system has at least four major drawbacks, which have become gradually more acute. These will be first listed and then examined in some detail.

1. As the underlying circumstances of various countries change in time, the initially fixed parities become inappropriate. As this happens, first tensions accumulate and, eventually, substantial discrete changes are forced on the system. The anticipation of these changes produces deeply disturbing speculative capital movements, and the execution is costly to the country making the adjustment. Thus, in the end, parities really do change, but in the worst possible way. Particularly disturbing (and still unresolved) problems arise when the country whose exchange rate has become inappropriate is the reserve-currency country (that is, at present, the United States).

2. Narrow bands have limited the ability of countries to carry out monetary policy suited for domestic stabilization; and, with increasing sensitivity of investors to intercountry differentials in short-term interest rates, this limitation has become gradually more stringent. Because of the size of the United States and its special role as provider of the reserve currency, this has meant, in practice, that other countries are increasingly forced to accept an interest policy imposed by American choice.

3. There is no adequate way of regulating the aggregate supply of international reserves; their creation through American deficits, not settled through other reserve assets, is haphazard. At the moment, it is generally deemed excessive, but there is no satisfactory mechanism for reducing it. And the creation of reserves through SDRs is a cumbersome process, hampered by lack of objective criteria for determining the appropriate amount.

4. With the short-term dollar claims convertible *de jure* but almost inconvertible *de facto*, every significant addition to the reserves of a major third country sends waves of tremors through the international financial community, besides giving rise to a chorus of acrimonious rebukes to the United States for running an uncontrolled deficit. There is, in fact, a well-grounded fear that if large conversions were forced on the United States there would be, at the very least, the danger of an unwarranted contraction in world liquidity and, at worst, the possibility that the United States might become "bankrupt," in the sense of being unable to carry out its obligations. Furthermore, the occasion for such crisis is increased by the fact that the surplus of any one country bears but an indirect relation to the American deficit, certainly far less direct than the layman is led to believe. A third country could experience a large surplus even if the United States were not running a deficit, or, indeed, even if it were running a huge surplus. This is because, under

the arrangement described in 3, any country experiencing a surplus on an official-transaction basis will initially acquire dollars which may well come from the deficit of other countries than the United States. Furthermore, ever since foreign central banks have started investing their dollar reserves in the Eurodollar market, it is not even true that the sum of all surpluses on an official-reserve basis equals the American deficit on that basis.

Comment on Items 1 and 4

With parities fixed, there is, in principle, a unique relation of the domestic price level (and interest rates) to the price level (and interest rates) in the rest of the world that is consistent with basic-balance equilibrium. Since price levels do not automatically respond promptly to imbalance, and countries are understandably unwilling to undergo the painful process of raising unemployment to reduce relative prices or of fostering inflation to increase relative prices, the fixed parities are bound to drift out of equilibrium. This drift, helped by the increasing liberalization of capital movements, has gradually occurred. Thus, eventually, discontinuous changes in parity have been forced on the system; and, because changes have been long delayed, and hence are large in size, they have produced deeply disturbing speculative movements. They have also been costly to the countries concerned, as speculators have gained at the expense of the monetary authorities.

The problem takes on a special dimension in the case of the United States. Since its official liabilities are a component of reserves, strictly speaking the equilibrium level of relative prices for the United States is that level which generates a deficit, on an official basis, equal to the "appropriate" growth in world reserves, less the "appropriate" growth in other reserves. Since gold does not grow, by present rules of the system, the growth in other reserves means growth of SDRs. Unfortunately, there is, at present, no objectively accepted criterion for what is the "appropriate" growth of total reserves; and the growth of SDRs is a very cumbersome process requiring the political agreement of an appropriate majority of the Fund members.

We have already noted that, with fixed parities, there is no effective mechanism to insure promptly that the American price level relative to the rest of the world will be such as to generate the "appropriate" growth of dollar reserves. We now see that there is also no way of agreeing what the "appropriate" level is. Hence, there must be, unavoidably, a continuous wrangle as to whether the deficit of the United States is excessive, too little, or just right. This is indeed an issue which has divided deeply both economic experts and political leaders.

At the present time, there seems to be growing agreement that, at least in recent years, the rate of deficit has been excessive. It is, therefore, also fairly generally agreed that, at current parities, the American price level is out of line with the rest of the world, although there is far less agreement as to just how far out of line it is. There is indeed even a "minority" that believes that the gap is small enough to be safely disregarded. The "minority" view is held, in part, by American experts claiming that the deficit is not excessive or can be handled by means other than a realignment of American prices; and, in part, in certain European circles holding that the excessive deficit does not reflect too low a trade surplus but only excessive capital exports. Hence, the cure would lie not in reducing the relative American price level in order to increase its export surplus, but instead in the United States taking measures aimed at curbing capital exports through which it is "buying up" Europe.

Whatever one's view on the extent of overvaluation, it is apparent to all concerned that the United States is not willing—or even realistically able—to bring about a rapid downward adjustment of its price level relative to the rest of the world. Under these conditions what would be called for is a one-time reduction of its parity *vis-à-vis other major currencies*. There are obviously two possible ways this could be accomplished:

- (a) by devaluing the dollar relative to SDRs and monetized gold, while the other currencies retain the old parity, or
- (b) by revaluing the other currencies relative to SDRs and gold, while the United States retains the old parity.

A substantial body of American opinion holding that a change in parity is appropriate refuses to consider alternative (a) on the grounds that the major important effects are really the same for all concerned under either alternative, while many "minor" considerations point to alternative (b) as economically and technically preferable. These "minor" considerations include such propositions as

- (i) a revaluation of monetized gold relative to the dollar could threaten the continuation of the two-tier system;
- (ii) a devaluation of the dollar relative to SDRs and gold could shake confidence in the dollar as a reserve currency, causing a collapse of the present system;
- (iii) if the rest of the world feels that their currencies are undervalued relative to the dollar, why do not *they* raise their parity relative to the dollar? This, of course, would imply that their

currencies would be revalued relative to SDR and gold; but why should anyone care, since the only parity that affects the American deficit is that with the dollar.

- (iv) the present parity with the dollar is enforced by foreign central banks supporting their parities by operating on the dollar market; hence, it is only *they* that can change this support level. There is, indeed, under the present set-up, no operational way in which the United States could reduce the market rates of exchange of foreign currencies with the dollar.

We shall have occasion to deal with all these arguments at various points below, and will only note at this point that argument (iii) can be used quite symmetrically to support alternative (a) over (b). However, what needs to be examined first is the argument that, in terms of major substantive effects, alternatives (a) and (b) should be regarded as equivalent by all "rational men." This argument deserves close scrutiny, because it is widely held (at least in the United States), while, in our view, it is untenable in at least one major respect.

There is, first, one essentially institutional reason why foreign central banks prefer devaluation by the United States over revaluation by themselves. Central banks hate to appreciate, because they then have to write down a portion of their assets, which creates complications in their own accounting and/or that of the government. However, we suggest that there is a far more fundamental economic argument to justify their preference for option (a).

Suppose that, under option (b), the currencies of other countries appreciate relative to the complex dollar-gold-SDR; then the reserves held by the rest of the world retain an *unchanged* purchasing power in terms of dollars, and have a *reduced* purchasing power with respect to all other currencies. On balance, their purchasing power is *reduced*. If, on the other hand, under option (a), the dollar is devalued, that portion of reserves consisting of dollar claims fares exactly the same as under option (b). But that portion consisting of gold and net SDRs (that is, the excess of SDR holding over SDRs allotted) has a higher purchasing power with respect to dollars and an *unchanged* one with respect to all other currencies. On balance, the purchasing power of total reserves *rises*. Hence, option (a) is distinctly preferable for the rest of the world.

Actually, the advantage of option (a) for the rest of the world (and its disadvantage for the United States) is, in reality, likely to be even greater. For, if the United States were to devalue, there would also be a "redistributional effect" among third countries. The gain to any country would be greater, the larger the share of their reserves held in gold

and SDRs, and the smaller the share in dollars. In short, there would be a relative loss for those countries which, in the past, have shown willingness to cooperate with the United States by holding their reserves in dollars instead of converting them into other reserve assets. It follows that under option (a) there would be an important loss of face and prestige on the part of the United States, to the advantage of countries and of political forces less sympathetic to the American position. Or, more likely, the United States would feel it necessary to show that it does not let its friends down by agreeing to compensate foreign countries for any loss on their net dollar-denominated claims on the United States (with proper allowance for the interest they have earned on their dollar reserves). This could be accomplished by issuing to them additional dollar claims as needed. With this further action, *all* the reserves of third countries would have increased purchasing power in terms of dollars, regardless of composition.

To summarize, the differences between the two options are not purely formal but, indeed, very substantial. The other countries are better off under option (a) than (b) (because their reserves are worth more), while the United States is either worse off in prestige, or worse off financially, or both. These considerations do not establish *per se* that one option is better than the other; but they do establish that the rest of the world is quite rational in preferring option (a) to (b), while the United States stands to gain financially, as well as politically, from option (b) versus (a).

There is, however, one further consideration which suggests that there is a case, on grounds of equity, in favor of option (a) over (b), particularly if we think of these options as relevant for the future. Assume that the overvaluation of the dollar relative to other currencies had resulted from American prices rising while other prices remained constant (or rose less rapidly), thus contributing to the rise in world prices. As long as all reserve assets bear a fixed parity to the dollar, this means that the American price behavior had caused a gradual erosion in the purchasing power of the rest of the world's reserves. A revaluation of other currencies is, in a way, a formal recognition of this relative loss of purchasing power. On the other hand, a devaluation of the dollar relative to other reserves would go in the direction of maintaining the purchasing power of reserves other than dollars. And, if accompanied by a compensation to the holders of dollar claims, it would maintain the purchasing power of all reserves and, in particular, the real value of dollar claims against the United States (that is, of the American debt). Since the assumption stated at the outset clearly has factual validity, we have established our equity case for option (a), accompanied by compen-

sation to the holders of dollar reserves for the net loss sustained, not covered by interest earned. More generally, thinking about the future rather than about the past, *if* the United States (the reserve-currency country) were to take the position that its parity with other reserve assets is *never* to be changed and, therefore, all reserves are, in fact, denominated in dollars, then all other countries have a very definite stake and vested interest in the maintenance of a stable American price level. A policy of "benign neglect" is thus not consistent with the United States retaining the role of reserve-currency country. There is, in this sense, a good deal of truth to a recent statement of French President Georges Pompidou that "We cannot keep a monetary standard which continuously loses value as a result of American Internal Policy." (As quoted by the Paris Edition of the *Herald Tribune* on May 26, 1971.)

Comment on Items 2 and 3

A country's ability to stimulate domestic activity by an expansionary monetary policy, and concomitant reduction of short-term interest rates, is constrained by the fact that the fall in interest rates creates an incentive for capital to flow out of the country, motivated by the favorable differential between domestic and foreign rates. It is well known that if the monetary authority has the obligation of preventing the market rate of exchange from falling outside some agreed band, then, as the differential gets large enough, the authority is forced to intervene in the exchange market and reserves begin to flow out of the country. This outflow, in turn, limits the achievable differential in two ways: (i) because it reduces the domestic money supply—that is, a portion of the intended expansion of the money supply "leaks out" in the form of reserve outflow; and (ii) because it drains the country's limited stock of reserves. Furthermore, the outflow of reserves tends to increase the money supply of the recipient countries, thus reducing their interest rates. While this helps the first country, by reducing the interest differential, it will tend to interfere with the desired monetary policy of the other countries.

It can be readily established that the maximum differential between the domestic rate of interest and the rate in other countries that can be achieved before reserves begin to flow out depends primarily on four factors:

- (a) the permissible band of fluctuations of the exchange rate;
- (b) the responsiveness of the basic balance to variations in the rate of exchange;
- (c) the responsiveness of the capital outflow to the so-called covered

differential spread; that is, the differential in the interest rates adjusted by the cost of hedging (by transactions in the forward market) against adverse movements in the rate of exchange at the time the lender wants to repatriate his capital;

- (d) the risk premium required by speculators in the forward market, who provide the cover.

Item (b) reflects certain basic characteristics of the economy, such as the elasticity of its exports and imports with respect to variations in the relation between domestic and foreign prices. For the present argument, this characteristic can be taken as given. It can then be shown that the maximum differential between domestic and foreign rates that can be maintained before reserves begin to flow can be expressed approximately as the sum of two components, as follows:

- (1) The first component can be written as B/t , where B is the total width of the band, and t is the maturity (measured in years) of the instrument whose yield we are comparing. (Thus, if the market rate of exchange is to be kept within $\frac{1}{2}$ per cent of parity, B is 1 per cent. Then, for the three-month rate, the term B/t equals $1/(\frac{1}{4}) = 4$ or 400 basis points. For the six-month rate, the term comes to 200 basis points, and so on.)
- (2) The second component of the maximum differential is more complex, but for present purposes, what matters is that it is positive; it grows large as the response coefficient under (c) above, call it R , gets low, and tends toward zero as that coefficient increases. It also tends to increase with the size of the risk premium.

We have seen under item 3, that, under present practice, B is somewhere between $1\frac{1}{2}$ and 2 per cent. However, in the early postwar period the responsiveness, R , tended to be small for many reasons. These include (i) outright restrictions on, and encumbrances to, capital movements; (ii) diffidence toward foreign investments, lack of familiarity with foreign instruments, and lack of information about their probable yields; and (iii) lack of an organizational network such as had existed in part in the predepression period but had died out during the 30's and the war years. In addition, the risk premium required by speculators was probably higher. As a result, in the early years of the system, central banks retained substantial freedom of domestic monetary policy. As the postwar period unfolded, each of the above factors gradually developed in the direction of increased responsiveness. In addition, a new important institution began to develop and flourish, namely