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Myths and Reality in the Development of International Monetary Affairs*

1 Discovering the Lesson of History

Documents attempting to establish a monetary order are like written constitutions. Produced with difficulty, often under dramatic circumstances, they reflect little more than a superficial consensus inspired by passing circumstances. Within a short time, events impose an unexpected pattern on the relationships that were supposed to be regulated. The monetary history of the modern era offers a smaller store of experience than its constitutional history, but it provides even clearer illustrations of the gap between documents and reality.

For the first time since the Church had ceased to concern itself with the matter several centuries before, a collective effort was mounted after World War I to establish an international monetary order. A false doctrine (albeit so deeply held that it has followers even today) maintained that the gold standard had been one of the essential elements of the lost paradise of the prewar world. An important characteristic of this system, at least as it was supposed to have existed, was the equality of national currencies before the "law of gold." Whether these currencies were issued by large or by small nations, the "law" was the same for all. It was deemed to derive from the natural order, like the laws of physics, and was in no way inconsistent with national sovereignty. This equality of rights and obligations for currencies is nowadays called "symmetry"; the word is new, but the illusion it represents has a venerable history. At a time when the economic, monetary, and political phenomena of the modern world were little understood, it was natural that people should want to reestablish the gold standard; it was the only system that had ever been devised and was identified with a certain economic, social, and political order that was considered the only proper one.

This doomed enterprise was launched at the monetary conferences of the League of Nations, particularly at the meetings of its Gold Delegation. With the advantage of hindsight, we can now see why it was impossible, even with a few modernizations, to recreate in the twentieth

* This essay was written (originally in French) during the Christmas holidays of 1973, just before the emergence of certain relevant developments. These developments —the further crippling of the European "snake," caused by the floating of the French franc, and the Rome Conference of the Committee of Twenty on International Monetary Reform—are briefly reviewed in a postscript.

century a system that worked in the eighteenth century and for a part of the nineteenth. First, it had worked much less perfectly than was imagined before studies were produced by a galaxy of economists (Gide, Bloomfield, Triffin, Lindert, Ford, Mundell, *et al.*). Second, the system had in fact been in abeyance for some decades as a consequence of the financial needs of an economic expansion that was more rapid than the growth in gold output and, even more, as a consequence of the invention of the telegraph and the development of political democracy.

The outcome of these efforts was christened the "gold-exchange standard." In practice, this meant an extension of the sterling area, which had grown out of the administrative and economic arrangements of the British Empire in the nineteenth century and was about to spread over most of the world, since it was now to embrace almost all the countries of Europe, including France. The transformation of the sterling system went some way toward meeting a need never before encountered for an international currency other than "clinking gold coins." Since past experience gave no useful guidance, people could hardly be expected to allow sufficient time for this new approach to provide a satisfactory solution to their new problem. Constantly undermined by intellectual confusion, economic illiteracy, and national selfishness—and by personal rivalries among some of the protagonists—the experiment collapsed at the beginning of the 1930s. The collapse contributed in large measure to the horrors of that decade.

Some time later, an attempt was made to improve matters. The inconsistencies in the celebrated automatic mechanisms of the gold standard were recognized, and the Tripartite Agreement of 1936 sought to pick up the threads of international monetary organization and make provision for the active management that was so sorely needed. Unfortunately, the techniques for successfully putting such arrangements into operation had not yet been developed, and this new approach also failed. It imposed special responsibilities on the monetary authorities of the three major powers of that time—France (leader of the old "gold bloc"), the United Kingdom (leader of a sterling area declining in importance), and the United States—as well as on the monetary authorities of other parties to the agreement (Belgium, the Netherlands, and Switzerland). The obligations stemmed from the principle of symmetry, and experience was once again to show that symmetry, even subject to controls, is not an appropriate principle for international monetary organizations, since national currencies are not equals. We now know that the market had already gone beyond the ideas of those who negotiated this agreement, and that the monetary authorities had themselves joined forces with the private sector to make the dollar the true

international currency by giving it functions that entailed special privileges.

Closer to our time, there was the Bretton Woods Agreement. What a strange edifice we have in the charter of the International Monetary Fund! The ideas of Keynes having been rejected, its theoretical basis was as obsolete in 1944 as were the ideas circulating in the corridors of central banks at the time of the Gold Delegation. The world had already been in the dollar era for some years, but the charter of the Fund ignored this fact and required—through its somewhat ambiguous convertibility regulations—a return to symmetry of rights and obligations. Once more the market, now encompassing the operations of many governments (including, at it turned out, those of the Communist countries), refused to respond to decrees, and the Bretton Woods system was never put into practice. At the beginning of 1959, the governments of the principal member nations ceased to take advantage of the transitional arrangements and accepted the "normal" regime as defined by the charter of the Fund. But within a few weeks at most, an "interpretation" of certain fundamental rules of the charter confirmed one of the major privileges that had accrued to the dollar, its supremacy as an intervention currency in the exchange markets, a supremacy the original documents certainly did not envisage. As a matter of course, the dollar had established its supremacy in other spheres as well; the market had imposed its decision in a manner too fundamental ever to be seriously questioned until the present moment.

The lesson to be drawn from this review of the past is clear. There is a noticeable gulf between the constraints and benefits that result from participation in the monetary arrangements dictated by the market and the legal rights and obligations that are supposedly established when monetary treaties are negotiated and ratified. This gulf has opened up several times in the last half-century, and now that the intention has once more been expressed to carry out a "reform of the international monetary system," we must ask ourselves what the chances of success are. Will the lesson of history be demonstrated once again or will ways be found to transcend it?

The idea of reforming the conduct of international monetary relations was launched about a decade and a half ago, if the story is taken back to Triffin's first recommendations during the early discussion of ways to disconnect the provision of international liquidity from deficits in the U.S. balance of payments. One of the first results was the decision in 1967 to create "Special Drawing Rights" (SDRs), which were to serve as a complementary reserve asset in the event of a closing of the American deficit—an outcome apparently desired by all parties, includ-

ing those most closely involved. The decision of 1967 was given effect in 1970, but it did not have the anticipated effect; actual developments, in fact, increased the asymmetry attaching to the status of the dollar. Following the two key events of 1971, the suspension of dollar-gold convertibility on August 15 and the Smithsonian Agreement of December 18, the world lived under a "universal dollar standard" until it was plunged into the profound monetary disorder of 1973. As might be expected from the historical precedents, the authorities responsible for reform felt that their task had become a matter of pressing urgency. In the course of the Annual Meeting of the IMF in Nairobi in September 1973, a first Outline of Reform was presented by the Chairman of the Committee on Reform of the International Monetary System and Related Issues. In his introductory report he said:

> The general shape of the reformed system has been defined and significant progress has been made on some important issues. Arrangements for adjustment and convertibility are to be effective in avoiding the protracted imbalances which led to the breakdown of the Bretton Woods system: symmetrical in relation to all member countries, large or small, developed or developing, in surplus or in deficit; and consistent with each other and with the volume of global liquidity. The SDR is to become the principal reserve asset of the reformed system, with the role of gold and of reserve currencies being reduced . . . .

The text of the first Outline, which no official representative accepted in its entirety but which "in the opinion of the Chairman" expressed the progress of the Committee's discussions, conforms to precedent by echoing the traditional leitmotif. It insists on a symmetry of rights and obligations between currencies. But it is at the same time revolutionary, at least in appearance, in looking to a reform which would base international monetary relations on a fiduciary instrument created by international agreement rather than on *national* fiduciary instruments like the pound or the dollar. One may well ask what the effect can be of putting a revolutionary plan to the service of an ancient illusion—the illusion of symmetry—and what the chances are of carrying out that plan.

2 Understanding the Lesson of History

In their international relations and the treaties they draw up, the fundamental attitude of nations derives from an ancient tradition. The full exercise of sovereignty is defined by three essential functions: the administration of justice, the raising of armies, and the striking of the coinage. The tradition of national sovereignty is particularly strong in the monetary sphere, even though experience has shown that it has

gradually lost its meaning for small and medium-sized nations, and that, in a world ever more characterized by the interpenetration of economies and the development of rapid communication, the tradition no longer corresponds to reality.

As long as national sovereignty was exercised over economies that were largely or almost completely self-sufficient, as was the case for centuries, national monetary action was monopolistic in nature. Even then, however, the monopoly was never complete. Although the state had the power—and often the exclusive power—to create legal tender, it could never enforce its use. Individuals and firms have always had a certain choice in the matter, at the cost of some inconvenience. The long-established response to growing inflationary pressure—and the most widespread response today—has been the flight from one national currency to another or to real assets (gold, land, property, antiques).

The state's monopoly in the monetary sphere was impaired more seriously in the nineteenth century with the first appearance of what is called the "international economy," that state of affairs in which an ever more important part of economic activity within the frontiers of a nation is dependent on transactions with the rest of the world. The first appearance of an international economy brought with it a need for an international money, and gold provided an early means of satisfying that need. But just as the goldsmiths of the medieval guilds, the bankers of Renaissance Italy, and the Hanseatic merchants of Germany, Holland, and Britain had invented financial instruments easier to handle than gold—promissory notes and bills of exchange—and just as gold was replaced by paper money within the frontiers of the established and new nations of the nineteenth century, a similar process was bound to emerge in international monetary relations, and for the same reasons.

Given a choice between the currency offered by the "local prince" and other monetary instruments, by what criteria was the choice to be made? One very old criterion, of course, was stability in value. At the outset of the modern economic era, another criterion, liquidity, became important, and this criterion is of greater interest in the present context. Thereafter, traders (and here, to a growing extent, we must include governments themselves, including, at a certain point, the Communist countries) were bound to choose the currency that would best satisfy these two criteria *simultaneously*.

The liquidity criterion corresponds to a fundamental economic objective—probably the most fundamental objective of all—the search for economies of scale. Moneys are like languages: if there is a choice among the media of communication (in the economic or intellectual spheres) that medium—money or language—will be chosen which enables the

operator to do as much as possible without being forced into exchange dealings or translation.

The savings—or profit—produced by the opportunity to avoid exchange dealings can be realized in all sorts of ways. First, as has just been indicated, traders dealing with the foreign sector of an economy incur expenses by continually switching from one foreign currency to another or from foreign to domestic currency. Gold by its very nature cannot meet these requirements, and so an "international money" is "elected." The market will "vote" for an international money by using or holding it in preference to other moneys. In this way, it will minimize exchange dealings. The currency elected will be one in which a very large number of transactions are settled or one that has certain prerogatives that make it attractive to the foreign sectors of other national economies.

The smaller a country with a high per capita income, the larger the influence of the foreign sector on its overall economy; furthermore, in the modern industrial world there is a tendency for foreign sectors to show more or less continuous growth. If we look only at current transactions, the foreign sectors of the Belgian and Dutch economies represent nearly 50 per cent of GNP; between 15 and 25 per cent of the GNP of France, Britain, and Germany; and about 6 per cent of the GNP of the United States (which is on the order of $1,200 billion, eight or nine times the GNP of France).

But traders are not simply concerned to minimize costs. The relative ability of financial centers to provide investment opportunities for the balances held in their national currencies is also important to the choice of an international currency. The center that wins out will be the one that gives holders of currencies the widest range of investment opportunities, the highest degree of liquidity in its investment instruments, and the greatest stability in the value of its currency.

It is an oversimplification to believe that all these considerations influence only the private sector, and mainly the banks. Governments face some of the same constraints to which private traders are subject when they choose an international currency in which to hold reserves or choose a reserve asset, such as gold, with a view to preserving their autonomy. The failure to recognize this similarity between the situations of private and official actors derives from a failure to understand the way modern economies work; it is also a source of ambiguity and even of misunderstanding with regard to the notion of autonomy or national sovereignty.

Consider first the role of the government or, more strictly, its "monetary authorities" (the Treasury and the central bank). These institutions are important in two ways. First, the recent but continually growing

intervention of the government as an economic agent that cannot ignore economies of scale gives it an interest in minimizing conversion costs and in the availability of liquid and high-yielding investments. Second, the more traditional role of the government as the holder of national monetary reserves has even more important consequences, since this is the mechanism through which monetary constraints originating in the foreign sector have their domestic effects. There is no way for the government to avoid this role, for two reasons: (a) It must foresee, and to some extent prevent, harmful effects on national economic welfare from more or less transient disturbances in the foreign account—disturbances caused by strikes, the business cycle, erratic price and supply movements, etc. (b) It must provide a service by holding a substantial stock of foreign currencies for delivery to private individuals and firms that, for various reasons, do not wish to hold these reserves themselves. The supply of and demand for foreign currencies by the private sector are subject to offsetting fluctations to some extent, and there is a net gain to the national economy from the readiness of the monetary authorities to hold reserves, so that individuals and firms need not hold liquid assets in foreign currency but can instead put their resources to more profitable uses.

Now consider the power of individuals and firms to choose the currency in which they keep accounts, make settlements, and hold reserves. The error is to assume that they will choose—or can be compelled to choose—the domestic currency. Their horizons are becoming less and less "national." To stress the risk of error in this assumption, it is sufficient to note that the "foreign" production facilities of all multinational companies were responsible for an output of goods and services of approximately $700 billion in the mid-1960s (i.e., about 40 per cent of the total output of the non-Communist world) or to refer to the considerable problems presented by the operations of multinational companies. When one reads in the report of the Finance Committee of the U.S. Congress for February 1973 that the liquid assets which could be shifted across frontiers were estimated at $268 billion, or when the executives of big American firms in Paris, London, Buenos Aires, or Singapore instinctively speak of the U.S. dollar as being the "home currency of the company," one feels a very long way from the dictum that "only the prince can strike coinage."

The elucidation of the lesson of history cannot be complete until we have cleared up an old ambiguity. In defense of certain monetary systems—for example, those based on gold—it has often been claimed that it is a matter of protecting a nation's monetary "independence" or "sovereignty." Whether deliberate or not, there is a confusion here between two very different things—on the one hand, independence, which,

properly defined, is the capacity to act with relative freedom from restraint, and, on the other, the desire to restrain the country or countries whose currencies have become international from exercising the consequent privileges. This second objective is likewise expressed in the search for a symmetry of rights and obligations; to realize this is to see very clearly the essentially political nature of that search. When one looks at certain episodes in the monetary history of recent years, one is tempted to use the language of Clausewitz and say that "money—or gold—can also be the pursuit of diplomacy by other means."

As for national independence in the economic sphere, it must be remembered that when the gold standard was in full force the whole world formed something like a monetary union; in other words, national independence in monetary policy was weak or nonexistent. And the most generally accepted reason for our inability to return to a system based on gold is precisely the narrowness of the constraints it would impose on national economic policies. I shall argue later that nations participating in a system dominated by a single national currency are likewise considerably restricted in their economic policies. The difference between the two situations is that under a gold standard it is the system as a whole that is subject to the constraint (the danger of insufficient liquidity), insofar as the price of monetary gold does not change, whereas, under a system based on a national currency playing an international role, the degree of liquidity of the system depends on the propensity of the reserve-issuing country to maintain a deficit in its balance of payments. Experience so far has been that this propensity is large and the lack of independence of the other countries under the system is a function of their relationship with the reserve-issuing country and of their passivity toward economic impulses originating there.

Another confusion that ought to be cleared up is created by the proponents of national independence when they take issue with the Keynesian tradition. It is helpful to distinguish between two aspects of the work of Keynes. On the level of ideas—on the scientific level, if one may use that word when talking of economics—Keynes was the principal initiator of a revolution in our way of looking at economic phenomena in general and monetary questions in particular. On the level of action, on the other hand, he made a major contribution to the alleviation of the distress of his time and country by revising accepted notions of economic policy and by his original insights into the scope for government intervention in the economic process. This is just what the "liberals" resent, whether they are the vanishing votaries of gold or whether they call themselves "monetarists." But Keynes, the principal modern critic of

the gold standard, was certainly aware of the constraints that can beset an economy as a result of the international monetary system. That is why he did not limit himself to certain recipes for full employment that depended on domestic political action, but went on to describe the external arrangements that would be necessary to the success of the policies he suggested. One of Keynes's recommendations was to break as completely as possible the link between the domestic economy and the rest of the world, and this led him to reestablish a place in economic policy for an instrument long spurned because of the predominance of the classical tradition—floating exchange rates. There was someone else at the time who emphasized that instrument, and with it barter agreements and exchange controls, and that was Dr. Schacht, Governor of the German central bank at the time of Hitler.

Given the general situation at the time and the priorities held by Keynes, it is difficult to dispute the consistency of his recommendations. But some of his methods, and even more those of Schacht, have become outmoded. The world has shrunk since the time of Keynes (development of communications); economic perceptions have changed (money illusion, an essential condition for success in devaluing currencies, is tending to disappear); the economic problems that have afflicted the world since 1945 have been quite different from those of the prewar era (inflation has become the scourge); and, finally, the policy instruments that can be used to break free from or reduce the dominance of an international currency have lost their effectiveness (in the case of exchange control) or are somewhat discredited (floating exchange rates) because they are liable to abuse or are alleged to be ineffective and harmful to welfare, particularly when applied between highly interdependent small or medium-sized economies. Something else is required to meet the needs of the modern world.

The treaty establishing the European Economic Community derives essentially from the realization that the countries of Western Europe are no longer large enough for the economic welfare of their populations. The treaty seeks to go beyond the nation-state as the fundamental unit of production and trade. The officials who negotiated it in 1958 did not know how far this process had already gone in the realm of monetary policy. Thus, outdated techniques were preserved in the monetary sphere at a time when the last traces of the principle of symmetry (the illusion of the equality of currencies) were disappearing and when events had already shown that the market's choice of an international currency could cause grave damage if that currency itself became the victim of economic disorder.