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REFLECTIONS ON THE INTERNATIONAL MONETARY REFORM

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Reflections on the International Monetary Reform*

It is, I feel, a great honor to have been asked to follow so many distinguished economists who have given this Frank D. Graham Memorial Lecture. I think of Frank Graham as one of the first to initiate me, through his writings, into the mysteries and perversities of floating exchange rates—which were as actual in the 1920s as they are today. I also remember him, with affection, as a person who could not have been kinder to me when I spent a few months in Princeton as a Rockefeller fellow some thirty-five years ago.

One of the most ambitious attempts ever made to achieve a synchronized and many-sided reconstruction of the international monetary system by an orderly process of multilateral consultation and agreement is now grinding to a halt. Its place will be taken, on the most optimistic assumption, by a series of piecemeal reforms, strung out over time at moments that appear opportune in the light of current developments on the international scene. It is not yet clear how much of the original effort can be salvaged in the form of an initial installment of reform. The whole episode is one that is instructive not only to the economist but also to the student of international affairs.

What was to be reformed, of course, was the international monetary system set up at Bretton Woods and administered by the International Monetary Fund, as that system had evolved up to, say, 1968. The most important features of the system, or at least those most prominent in the reform discussions, were the following:

1. The exchange-rate system, i.e., the manner of regulating exchange rates
2. The intervention system, i.e., the manner in which these regulations are implemented by exchange-market intervention
3. The settlement system, i.e., the manner in which currencies acquired in intervention can be used to obtain other reserve assets and in which the currencies required for intervention can be obtained in exchange for these assets

*This essay contains the text of my Frank D. Graham Memorial Lecture, delivered at Princeton University on April 18, 1974.

4. The international reserve system, i.e., the manner in which the aggregate supply of reserves and its composition are determined.

Background

The first part of the international system to be reformed was the reserve system. In the latter half of the 1960s, it became clear that reserves were not increasing fast enough to keep pace with the expansion in the need and demand for them called for by the growth of international transactions. This was particularly true of the gold component of those reserves, but it was also true of reserves as a whole, despite the steep rise in the dollar holdings of central banks made possible by recurrent U.S. payments deficits and by the willingness of other countries to hold the proceeds of the corresponding payments surpluses in U.S. dollars. It came to be recognized, thanks in large part to the work of Professors Triffin and Kenen, that the method of meeting the world's reserve needs through an expansion in currency liabilities convertible into gold or other currencies was an inherently unstable one, that it tended to bring about maladjustments as well as instability in the payments balances of the countries issuing these currencies, and that it should, if possible, be replaced by something better.

The first step toward a solution of this problem was the creation of a new type of international fiduciary reserve asset, the Special Drawing Right (SDR), issued by the IMF and distributed among countries on the basis of Fund quotas. This solution, adopted in 1969, took years to prepare. By way of comparison with the procedures adopted later for the main reform, it is interesting to note that the first stages of preparation of the SDR scheme took place primarily in the Group of Ten, an exclusive club consisting of the main industrial countries, and the final stages primarily in the IMF itself.

It soon became obvious that, while the SDR provided a technique for relieving any shortage of reserves, merely to add a new type of reserve asset gave no assurance that the total volume of international liquidity would be kept under international control if autonomous forces were to create an excessive amount of reserves in other forms—in the form, for example, of currency balances.

Moreover, the feeling had been growing throughout the 1960s, first among academics and then among officials, that the Bretton Woods arrangements might require amendment, not only with respect to liquidity supply but also with respect to the adjustment process in general and the exchange-rate regime in particular. During the 1950s and early 1960s, the process of balance-of-payments adjustment worked remarkably smoothly. In a world in which, outside the United States, gentle demand inflation prevailed and capital movements were limited, most countries tending to run into payments deficit could get back into line, without too much sacrifice of domestic prosperity, by temporarily checking the expansion of demand. Progressively during the 1960s, however, these conditions changed. The increasing importance of cost-push elements made for differential rates of inflation as between countries and created basic disequilibria that were difficult to correct without altering exchange rates. Although the rapid growth in the international mobility of capital (previously marked only as between the United States and Canada) sometimes helped to tide over payments imbalances, more frequently it tended to accentuate them, especially when doubts grew as to the possibility of defending existing exchange parities. The long siege of the pound sterling ending in the devaluation of the pound in 1967, the upward pressure on the D-Mark and the *événements* in France ending in the devaluation of the franc and revaluation of the Mark in 1969, followed by the upward float of the Canadian dollar in 1970, persuaded officials to take somewhat more seriously some of the suggestions for flexible exchange rates that had been made by academic economists in the early and mid-1960s.

An examination of these problems was conducted by the Executive Directors of the Fund in 1969-70 and eventuated in a report on *The Role of Exchange Rates in the Adjustment of International Payments.* This 1970 report, it must be said, was cautious and tentative in its conclusions. Its authors were still much influenced by the long years during which the Bretton Woods arrangements had worked very well. Floating exchange rates as a permanent regime, substantially wider margins of fluctuation around parity, and automatic crawling pegs were all rejected. Par values should be retained but should be changed more promptly after the emergence of a fundamental disequilibrium, not—as too often had been the case—belatedly, as a last resort. Further consideration should be given to two more radical innovations: (1) a slight widening in the margins around parity to dampen down short-term capital flows and help smooth the transition from one parity to another, and (2) the authorization of strictly temporary periods of floating, but only in exceptional circumstances and under safeguards adequate to protect the interests of the international community.

These cautiously forward-looking proposals were soon to be swamped and lost to sight in a torrent of events that revealed the necessity for much more fundamental changes in the system. In the latter part of

1970 and in 1971, speculation against the dollar set in and official dollar reserves multiplied threefold from end-1969 to the third quarter of 1971. When one or two countries began to demand the conversion of their dollar balances, the United States was compelled, in August 1971, to abandon convertibility and the sale of gold.

The flood of dollars, and particularly the removal of what had been considered to be the linchpin of the par-value system, caused a tremendous shock to confidence. Many, and finally most, of the principal currencies began to float; the United States kept urging Japan and the Europeans to float up and to revalue; these countries, in turn, considered that the United States should devalue. In the end, a temporary compromise was arrived at in the Smithsonian Agreement of December 1971 with a mixture of devaluation by the United States and revaluation by others, and with a widening of the margins of fluctuation around parities from plus or minus 1 per cent to plus or minus 2¼ per cent.

Suggestions for Reform by the Fund's Executive Board

These developments suggested that a much more thoroughgoing reform of the international monetary system was required, and at the Fund's Annual Meeting of Governors in September 1971 the Executive Directors were asked to report on the measures necessary for this reform. They duly reported in August of the following year. In this report (Executive Directors to the Board of Governors of the Fund, *Reform of the International Monetary System*, Washington, International Monetary Fund, 1972), most of the themes that dominated the later phases of the reform discussions were introduced. Some of the new ideas, particularly those of asset settlement and substitution, received a fairly elaborate treatment.

Asset settlement was put forward as a possible substitute for convertibility. Under the system of Bretton Woods, most countries settled their payments surpluses and deficits, apart from the use of special credits, by variations in their reserve holdings. Countries whose currencies were used in intervention and held in reserves, however, and particularly the United States as the issuer of the central intervention currency and principal reserve currency, might settle their payments imbalances through variations in their liabilities to foreign central banks. The extent to which the United States settled in assets or in liabilities depended, at least in theory, on the decisions of the foreign holders as to whether they would or would not exercise their right to convert their dollar balances into gold. It was therefore conceivable that the United States could gain reserves when in deficit and lose them when in surplus. In practice, holders of dollars were expected to show some restraint in using their conversion rights, and the United States, particularly from 1970 on, financed its deficits in the main by increasing its liabilities.

The idea behind asset settlement was to put reserve centers and others on the same footing—to regulate conversion in such a way that reserve centers, like other countries, settled their deficits and surpluses through the transfer of reserve assets, except insofar as they, like other countries, might obtain negotiated credits. One of the main advantages seen in this arrangement was that it would complete the work, begun by the creation of the SDR, of bringing the world's supply of reserves under international control: SDRs would ensure that there were enough reserves, asset settlement that there were not too many. A second advantage was that it would subject reserve centers to the same sorts of pressure for adjustment when in deficit that other countries in that position had to bear, although this was not seen as an advantage by everyone. Finally, this arrangement would protect the reserve centers against the possible conversion of the overhang of liabilities to central banks that had accumulated in earlier years.

I will not describe in detail the mechanisms whereby asset settlement was to be assured. Broadly speaking, two main techniques could be employed, alternatively or in combination. Under the first approach, all countries, or at least the principal ones, would undertake to prevent their stocks of each reserve currency from rising by converting accruing balances into primary reserve assets, and possibly prevent them from falling by selling primary assets to the issuer. Under the second, or collective, approach, reserve centers would regularly settle any net increases or decreases in outstanding reserve liabilities either by exchanging SDRs and their currencies with other countries designated by the Fund or by exchanging SDRs and currencies directly with the Fund. This collective approach to asset settlement, which certainly seemed the simpler of the two so far as the traditional reserve currencies are concerned, led naturally into another suggestion, which constituted the second of the two new ideas advanced in the 1972 report, namely the idea of a substitution account.

The substitution account or substitution facility, as suggested in the 1972 report, was to be an account in the Fund that could exchange currencies and SDRs with central banks. It would have two main features. First, it would enable countries to alter the composition of their reserves by selling to them—or standing ready to sell to them—newly created SDRs in exchange for their holdings of reserve currency, and possibly (though this feature was subsequently dropped) by selling reserve currency to them in exchange for SDRs. Second, it would ensure that reserve centers were able to earn reserves through their surpluses by standing ready to buy their currencies from them in exchange for newly created SDRs to the extent that other countries' holdings of their currencies declined. And it would ensure asset settlement by the reserve centers, if this was not otherwise provided for, by requiring them to redeem their currencies from the account with SDRs to the extent that other countries' holdings of their currencies increased. In its first aspect, its transactions with non–reserve-currency countries, the substitution facility would have the effect of increasing the role of the SDR in reserves and reducing that of currencies, thus weakening the temptation for these countries to devalue their own currencies whenever their reserve currency was devalued and paving the way for systems in which the SDR would be the principal means of settlement. In its second aspect, its transactions with reserve centers, which came to predominate as the reform discussions proceeded, the facility would be an instrument for implementing asset settlement.

These two main innovative suggestions of the 1972 report, the idea of asset settlement and the substitution facility, were not received with unalloyed enthusiasm by all countries, and especially not by the United States. It is easy to see why. Asset settlement, while it might protect the principal reserve center against the conversion of outstanding balances of its currency, takes away from it a valuable source of liquidity, the ability to finance deficits by the expansion of its liabilities rather than the loss of its reserves. In other words, the reserve center when in deficit would be under the same pressures to deflate, restrict, and devalue as other countries in deficit normally are. Moreover, the United States, being not only the principal reserve center but also having the ultimate intervention currency, and being accustomed to playing a passive role in exchange markets, might well feel that other countries were in a position to put her into deficit and keep her there. Other countries when in deficit were at least free to devalue their exchange rates or float their rates downward. The United States, as the intervention center, was not able to float its currency and might not be allowed to devalue effectively. Asset settlement, unaccompanied by other reforms in the adjustment and intervention system, might weaken the incentive for industrial surplus countries either to adjust upward themselves or to allow the United States to adjust downward through the rate of exchange.

As for substitution, it might add to the freedom of action of the reserve-currency countries, but questions would arise as to the terms on which the substitution would be carried out and as to the form in which the claims of the substitution account on the reserve center would be held.

For the United States, certain other aspects of the reform program had a greater attractiveness, namely, proposals for increasing the pressure on other countries to adjust when in surplus, and perhaps also proposals for changing the intervention system to give greater freedom to the United States to alter its own exchange rate.

The 1972 report considered adjustment mainly from the standpoint of the exchange-rate regime. In addition to repeating the suggestions of the 1970 report regarding prompter par-value adjustments, slightly wider margins, and temporary floats, the later report put emphasis on the need to allow the United States greater initiative in changing its own rate without being exposed to retaliatory measures, and on the positive expectation that countries would change their rates whenever they fell into fundamental disequilibrium rather than merely abstain from changing their rates when not in fundamental disequilibrium. Having in mind the experience of the year 1971, the report emphasized the need for simultaneous joint consideration of the relative exchange rates of all the principal currencies and for the initiation of a process of continuous assessment that would make this possible. Ideas were also tentatively put forward, with pros and cons, for granting greater initiative to the Fund to suggest the need for changes, for using quantitative statistical indicators to create a presumption of the need for change, and even for providing pressures and penalties that could be applied to countries that did not alter their rates when change was found to be necessary. All this constituted a line of thought that received further development in the later stages of the reform discussions.

Another idea which got a first airing in the 1972 report was that of shifting from an intervention system in which all currencies were directly or indirectly pegged to the dollar to one in which intervention was somehow made much more symmetrical. This notion, which I have personally regarded as of crucial importance, comes in two modes: SDR intervention and multicurrency intervention. Under SDR intervention, central banks buy and sell their domestic currencies in exchange for SDRs at a fixed margin around par in transactions with private parties, who are free to transfer the SDRs between central banks. Under multicurrency intervention, the central banks buy and sell each other's currencies in transactions with the foreign-exchange markets at fixed margins around their bilateral parities. Only multicurrency intervention is mentioned in the 1972 report. There it is seen as a way in which the U.S. dollar could have the same effective margins of exchange-rate variation as other currencies; a way in which asset settlement could be reinforced—assuming that all accumulating balances under such a system would be settled promptly in primary assets or third currencies; and a way in which the dollar could float, if the United States were unable to maintain its convertibility, without other currencies having to float too. This scheme had some attractions both for the United States and for the Europeans, who, indeed, were already operating something similar within the European Economic Community.

The elements of the reform program I have outlined so far were not too attractive to the less developed countries. Of course, they stood to gain indirectly from anything that would improve the adjustment process for industrial countries and enable the latter to avoid balance-of-payments difficulties which they might be tempted to relieve by applying restrictions to imports, capital exports, or aid. But the particular techniques suggested were not generally to the less developed countries' taste. Whatever they might do about their own exchange rates, the primary producers did not welcome variability in the relative exchange rates of the principal currencies. Such variability might make it difficult for them to stick to their practice of pegging narrowly on a particular intervention currency and might involve them in competitive uncertainties vis-à-vis primary producers pegging on other currencies. Asset settlement threatened to rob the reserve-management system of an expansionary bias to which these countries, quite rationally, had no objection. Schemes for substituting low-yield SDRs for high-yielding currency reserves had no great charm for them either. Consequently, their tendency was to look for some compensating feature of the monetary reform that would be decidedly to their benefit and to make that a condition for their cooperation.

The nature of this compensation was not far to seek. It had to have something to do with improving the flow of real resources from developed to less developed countries, a flow which had for some years been declining as a percentage of world real income. Ever since Stamp mooted the idea in the 1950s, schemes had been current under which international reserve assets, created to meet the world's liquidity needs, could be used for the benefit of less developed countries, thus diverting to the latter the seigniorage which under the gold-exchange standard accrued mainly to the benefit of the United States. Two main forms of a "link" between SDR creation and economic development were mentioned in the 1972 report. Under one of these, SDRs would be allocated to development-finance institutions and used to finance development expenditures on concessionary terms. Under the other, the SDRs that would normally have been allocated to developed countries would be diverted to less developed countries. This began as a highly controversial proposal and was to remain so.

Deliberations of the Committee of Twenty

All the suggestions contained in the 1972 report were advanced in the most tentative way and garnished with "pros" and "cons." It was clearly necessary, if a reform as many-sided as that under contemplation were to be agreed upon, that the financial authorities of the Fund's member countries, both ministers and senior permanent officials, should first make themselves familiar with the complex and rather esoteric subject under discussion and then make the necessary choices among the various possible arrangements. The reform process therefore moved into a new phase. In July 1972, the Governors of the Fund appointed a committee at ministerial level, containing one member and two associates for each of the twenty constituencies that choose an Executive Director of the Fund, and charged this Committee of Twenty (C-XX) to advise and report on all aspects of reform of the international monetary system. They also set up a committee at deputy level to formulate proposals for approval by the Ministerial Committee. Finally, the Chairman and four Vice-Chairmen of the Deputies, sometimes described as the Bureau, formed a high-powered secretariat to draft these proposals for approval by the Deputies.

The method of work adopted by the Deputies and Bureau was one that has seldom been applied in international affairs to such complex and highly technical issues. It was extremely democratic, extremely thorough in its educative effect on the participants, and extremely demanding on the time and energies of all concerned. When the Articles of Agreement of the Fund were hammered out, at and prior to Bretton Woods, it was on the basis of two or three alternative drafts, each elaborated in considerable detail and in self-consistent form by the experts of a major country. On the present occasion, a much more Socratic procedure was adopted. On the basis of general discussion, couched in terms appropriate to the degree of understanding achieved at the time by the senior officials involved, the Bureau sought to elicit points of agreement and clarify points of difference on all the manifold and interrelated issues, and to resubmit the results for further general discussion. Very few of the major countries established coherent national positions over the whole range of these issues, and only one of them, the United States, brought out a fairly comprehensive statement of its position. Even that was not comparable in clarity and precision to the Keynes and White plans of former days. The Europeans handicapped themselves by trying to agree issue by issue on a joint EEC position. The less developed countries made great efforts to agree on a common program of reform through the Group of Twenty-Four, but this agreement was inevitably confined to a few isolated matters of common interest, such as the nature of the link between SDR creation and development finance.

Initially, it was hoped that an Outline of Reform could be presented within a year. This was an unrealistic goal based on a radical underestimate of the complexities of the problem. In fact, it has taken much longer than that, despite the labors of several working groups, for the technical issues to be fully clarified, if indeed they have been fully clarified. This long-drawn-out educational process is not to be regretted. In the first place, it was necessary if countries were to understand what they were getting into. And, secondly, changes that were taking place at breakneck speed in the real world were such as to throw doubt on some of the features of the reform as originally conceived.

The first fruits of these deliberations under the C-XX's auspices were set forth in the First Outline of Reform presented to the Fund Governors in Nairobi in September 1973. This Outline, though prepared by the Bureau—the Chairman and Vice-Chairmen of the Deputies—without commitment on the part of any government, reflected the stage then reached in the C-XX's discussions. Though the Outline did not, save in a few particulars, show any great substantive advance on the 1972 report of the Executive Directors, it gave rather fuller expression to the American point of view, which had by that time been more fully worked out. It also took some account (though less, perhaps, than one might have expected) of the fact that, in the meantime, the provisional Smithsonian system of parities and central rates had broken down; most European currencies, though tied together in the EEC "snake," were floating free of the U.S. dollar; and the pound, the lira, and the yen were floating on their own.

As regards the adjustment process, the main innovations of the Outline were as follows. Surveillance of the adjustment process, at least so