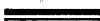


ESSAYS IN INTERNATIONAL FINANCE

No. 107, December 1974



REFLECTIONS ON THE
INTERNATIONAL MONETARY REFORM



J. MARCUS FLEMING



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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PETER B. KENEN, *Director*
International Finance Section

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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

far as imbalances of international importance are concerned, should be carried out at special meetings of a high-level body in the Fund. In that process, considerable importance would be attached to automatic reserve indicators: They would play a role coordinate with the initiative of the Managing Director of the Fund in triggering consultations about a case of imbalance; they would have a major—the North Americans said a presumptive—role in determining the need for adjustment; they might also operate presumptively, or even automatically, in triggering financial pressures on surplus countries in the form of negative interest rates on their excess balances. Despite a certain amount of verbal obscurity, it could be discerned that the type of indicator favored for these purposes related to reserve levels rather than reserve flows. Thus, Robert Triffin's "fork" proposal for relating adjustment action to reserve levels, which, of course, reproduces one aspect of Keynes's Clearing Union proposal, finds a certain echo here.

Actually, the case for using reserve levels to trigger financial sanctions is much better than the case for using them to indicate the need for adjustment. The imbalances to which they point are past rather than present ones, and to use them to trigger adjustment might set up an oscillatory process. As signals for sanctions, on the other hand, they might cast their shadows before and evoke corrective action at an earlier stage.

The Outline is rather vague as to what is meant by adjustment and, indeed, as to what kinds of imbalance adjustment is supposed to correct. The old distinction between fundamental and other disequilibria is nowhere mentioned. The Fund is not given the formal right to recommend a change in exchange rates or, indeed, any specific type of adjustment measure—which may be a genuflection to national sovereignty but seems to me a backward step. In the sphere of exchange rates proper, the principal innovation of the Outline is that, while the par-value system is retained, floating rates are now regarded as a legitimate and useful technique "in particular situations" and no longer merely as a temporary or transitional device. Floating rates are, however, to be subject to Fund authorization and surveillance—a subject to which I shall revert later on.

On the mode of settling payments deficits and surpluses, American attitudes hardened, during the discussions under C-XX auspices, against mandatory asset settlement and in favor of something more like the old system of "on demand" convertibility. The new version differed from the old in that countries of intervention currency could obtain protection, if they wished, against any net conversion of outstanding balances,

and countries that had accumulated excessive holdings of primary reserve assets would be denied the right to convert further accruals of reserves. The general tendency of these proposals, as of the proposals about objective reserve indicators, was to bring more adjustment pressure on surplus countries and to leave to the issuers of intervention currencies possibilities of financing their deficits in an informal way through the growth of reserve liabilities over and above any recourse to formal credit facilities. In justice, it should be added that, under multicurrency-intervention arrangements, such flexibility in external financing would be available not merely to traditional reserve centers but to all participants in the multicurrency-intervention scheme, constituting, perhaps, some ten to twenty countries.

By contrast with these views, industrial countries outside North America tended to favor tight asset settlement relieved only by formal credit arrangements under international supervision. Putting it very broadly, one might say that the Europeans favored symmetry of settlement arrangements as between reserve centers and others, while the Americans favored symmetry of adjustment pressures as between surplus and deficit countries.

On the matters just discussed, it cannot be said that great progress toward agreement has thus far been made under C-XX auspices. A more hopeful development has been the tendency toward a convergence of view in favor of a more symmetrical intervention system. This was still treated somewhat tentatively in the 1973 Outline, but since then a good deal of work has been done on it. Multicurrency intervention is still the preferred technique for achieving symmetry and is generally considered to be feasible technically for the ten to twenty countries that would be likely to participate in it. Other countries would defend their margins around parity by intervening in one or several of the currencies of the multicurrency intervenors. Rules have been suggested to govern the trickier aspects, such as intramarginal intervention and the assets to be used in settlement. I feel that, if par values are ever restored, an attempt will probably be made to go over to such a system.

One of the surprises of recent discussions, however, is the amount of support that has built up among a few European central bankers and the great mass of developing countries in favor of the alternative system of symmetrical intervention, namely, intervention in SDRs. This does not now mean a system in which SDRs are owned and traded by private persons. Central banks would sell for domestic currency, at a fixed margin, promises to deliver SDRs to other central banks, and would buy rights to receive SDRs from other central banks, in deals arranged

for a profit through the private market. The arbitrage operations of the market would then keep exchange rates within limits determined by the SDR margins. This scheme charms the central-bank technicians because of its resemblance to the gold standard, and attracts the less developed countries because they could participate if they wished on an equal footing with the main industrial countries, which is not the case with multicurrency intervention.

While the idea of using the SDR as an intervention medium is still somewhat new and strange, there has been an encouraging degree of unanimity, at least in theory, that it should become the principal asset of settlement between central banks and, in time, the principal reserve asset of the system. These roles are interconnected. If, as many advocate, the SDR is to be the only mandatory settlement asset, it must be available in large amounts in reserves. The logic of this has helped to reduce the resistance of many to the idea of a substitution facility in which SDRs could be obtained by monetary authorities in exchange for currency reserves.

Unresolved Issues

Such progress toward consensus, however, has been slight. Not only are the big issues of asset settlement and automaticity in the adjustment process still unresolved, but there are some problematic areas of crucial importance in the international monetary system where little or no progress has been made in finding solutions. One of these areas concerns the role of gold in reserves. If the SDR is to become the principal reserve asset in the monetary system, gold must be gradually eliminated from it. But, in practice, all the methods for dealing with gold in the Outline would involve increasing its value share in world reserves. Even the proposal least favorable to gold would allow central banks to sell it on the market at market prices, thus in present conditions quadrupling the value of gold reserves as compared with the present monetary price. This proposal at least leaves open the possibility that such market sales would bring down the price. Alternative proposals, which would allow central banks to sell gold to each other at market prices, or even buy from the market, would ensure that this did not happen and would make it much more likely that gold, rather than SDRs, would be the growing element in world reserves.

But the real Achilles' heel of the reform discussions lies in yet another area, the failure to generate a sufficiently convincing international program for handling the ever-growing problem of disruptive capital

flows or, more generally, of short-term instability in balances of payments under a par-value system. This problem was rather thoroughly examined in a working party, and the whole armory of national techniques for dealing with payments imbalances—including capital controls, domestic financial policies, exchange-market techniques, and official financing—was passed in review and evaluated. Some rather novel and interesting techniques, such as dual exchange markets, were discussed. The usual recommendations about international harmonization of monetary policies, prompt adjustment of par values, and international financing were repeated. But it is difficult to feel that anything short of heroic measures of recycling could make the par-value system viable in the presence of such flows, or that anything short of floating rates could check or canalize the flows and thus protect countries' monetary systems from external shocks.

Oddly enough, it was something lying entirely outside the sphere of the international monetary discussions, a sudden and catastrophic change in the price of a major primary commodity, crude oil, that led to an equally sudden decision to bring to a quick conclusion the efforts at achieving international monetary reform under the auspices of the C-XX. Even before the reduction of Arab oil exports and the hoisting of oil prices in December 1973, doubts had been growing regarding the prospects of reaching simultaneous agreement on all the international aspects of a comprehensive reform, and regarding the realism of an agreement based on the restoration of a par-value system in a situation where not even all the EEC countries seemed able to maintain par values among themselves. The inability of the pound sterling and then the lira to stay with or return to the "snake"—an inability, incidentally, in part attributable to steep increases in the prices of foodstuffs and raw materials—tended to intensify these doubts. The shock of oil-price increases that caused current-account shifts of the order of \$60 to \$80 billion made it inevitable that floating rates would become still more widespread and would persist for some time to come.

The decision of the C-XX, at its Rome meeting in January 1974, to wind up its operations by the middle of the year did not mean that international monetary reform was to be abandoned, but only that it should be accomplished on a gradual and piecemeal basis and that it should be worked out in a somewhat different forum. The ministerial committee would, in effect, be perpetuated under different names, as the Interim Council and the Council of Governors, with functions no longer confined to reform. But the Committee of Deputies, together with its Bureau of Chairman and Vice-Chairmen, would lapse, and their

function in preparing the work of the ministerial body would, in effect, be taken over by the Executive Directors of the Fund.

It is hoped that the C-XX may be able to agree on certain elements in the ultimate reform by the middle of the year, but it seems doubtful whether consensus can be achieved at this time on anything beyond broad generalities. It may be possible, however, and indeed it is urgently necessary, to make certain practical arrangements—some of them involving legal changes—to deal with the problems of the interim period.¹ One such arrangement has already been authorized in principle by the C-XX and is being worked out by the Executive Directors, namely, an arrangement for valuing the SDR in terms of a combination of currencies rather than of a single currency, the U.S. dollar. This should give the SDR, and with it the value of positions in the General Account of the Fund, a higher degree of stability than belongs to any single currency in a floating world and should therefore facilitate the use and receipt of SDRs, the use of the resources of the General Account, and possibly the creation of new types of international credit facilities, which are so much required in present circumstances.²

The big question now, however, is whether it is going to be possible to work out a way of living with floating rates that would be compatible with the maintenance of international harmony and that, without sacrificing internal prosperity, would preserve a measure of exchange stability and stability in the conditions of international trade and investment. An answer to this question is necessary whether the present state of generalized floating is perpetuated or a par-value system of sorts is re-established, for the latter is likely to mean the establishment of a revolving core of countries maintaining reciprocal parities from which individual countries would float off from time to time as their currencies came under heavy pressure.

The question of guidelines for floating is under consideration both in the C-XX and in the Executive Board. The main issue is whether market intervention should be confined to smoothing of day-to-day and week-to-week fluctuations in exchange rates, and possibly to the mod-

¹ The Outline of Reform, as adopted in June 1974, indicated, in Part I, the general direction in which the C-XX believed the system might evolve; set forth, in Part II, a number of steps, mostly of an institutional and procedural nature, which the Committee agreed should be taken immediately or on which work should be done; and suggested, in the Annexes, illustrative schemes in various areas of the reform (see "Outline of Reform Supplement," *IMF Survey*, June 17, 1974).

² For the precise mode of valuation of the SDR as ultimately adopted, see IMF Press Release No. 73/34 of July 1, 1974, as reproduced in *IMF Survey* for July 8, 1974.

eration of movements lasting over a period of months, or whether intervention designed to resist undue deviations in the rate from a reasonable estimate of its medium-term norm should be permitted and even encouraged. A second question concerns the extent to which reserve levels should be used to provide an indicator of the need for the latter type of intervention. A third question concerns the extent to which measures designed to influence capital flows—including fiscal-market intervention, capital restrictions, dual rates, and even monetary policies, insofar as they diverge from those required for internal stability—should be subjected to rules similar to those applying to spot intervention. All this is clearly a very sensitive area in which governments will be loath to tolerate effective surveillance by international organizations; yet, without it, chaotic conditions leading to accusations of antisocial behavior may well arise.³

Still further problems loom up behind. Market intervention is carried out entirely in currency. Such intervention affects the value of the intervention currency as well as of the currency of the intervening country. The extension of floating to many members of the EEC has led to a narrowing of the sphere of organized multicurrency intervention and a restoration or intensification of the situation in which the great bulk of the intervention is carried out in dollars. This threatens to perpetuate the asymmetries and the limitations on the freedom of action of the United States, which it was one of the main objects of the reform to remove. Should there be rules of the game relating to which currencies can be bought and which sold in intervention, or should this be left to bilateral haggling? Can there be any rules of this kind without a fairly massive prior substitution of newly created SDRs for existing currency balances?

Then there is the question of world reserve management. If countries can buy any currency they want and sell any currency they have, or even if such intervention is negotiated bilaterally, there can be multiplied expansions and contractions of world reserves beyond international control. Would it be possible to check this by introducing arrangements for asset settlement even under floating? Clearly, this would not be possible if countries were free to buy whichever currencies they desired. Might it become possible if the choice of currencies were regulated?

It might be objected that all this no longer matters; that under float-

³ The Guidelines for the Management of Floating Exchange Rates, as adopted by the Executive Directors of the Fund on June 13, 1974, and endorsed by the C-XX as an arrangement for the present period of widespread floating, are set forth in the *IMF Survey* for June 17, 1974.

ing rates the world supply of reserves will no longer have to be regulated but will regulate itself; and that, if there are too few reserves, countries will bid up the currency value of existing reserves by buying them and, if there are too many, will reduce their currency value by selling them. But such a system would work satisfactorily only if all reserves consisted of primary reserves—gold or SDRs—that were bought and sold in the market. Otherwise, the supply of real reserves would adjust to demand only at the cost of creating disequilibria between reserve-currency countries and other countries.

Conclusion

From what I have said, it should be clear that general resort to floating rates is far from solving all the problems of the international monetary system. The question is: Can all these problems be solved *ambulando*, one by one, or is it still going to be necessary, not only for political reasons but for reasons of economic consistency, to put together at some point a package of mutually complementary reforms? Only the future will tell, but obviously no package can be put together until experience with floating has convinced most people either that a tolerable international order can be worked out on a floating basis or that it is desirable as well as feasible to resume the effort to create a central system of par values, though one containing greater pressures for adjustment and more safety valves for floating than existed under the former system.

In any event, we shall have to wait until the turbulence in the international monetary system dies down somewhat. The attempt to work out a complicated trapeze act while simultaneously shooting Niagara has not proved successful. At every stage in the discussion, reform proposals have lagged behind events and have been quickly outmoded by new events. Perhaps, in time, the pace of change will slacken and it will become possible for thought to catch up with fact and for the experts to devise and the politicians to accept a new order suitable to the new conditions.

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