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FRITZ MACHLUP, *Director*

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A DOLLAR-RESERVE SYSTEM AS A TRANSITIONAL SOLUTION

The deadlock in the debate on international monetary reform reflects apparently irreconcilable positions on several planes, some of them overlapping: whether there is, or will soon be, too much or too little international liquidity (however defined); whether the gold-exchange (or reserve-currency) system is basically a satisfactory arrangement or is highly dangerous and in urgent need of replacement; whether such replacement ought to take the form of a system based on gold—rigorously, à la Rueff, or at least anchored to it—or a system based on international credit creation; whether international credit creation would be multi-national or supranational, and in either case, which countries would participate in, and decide on, credit creation, and how.

This list does not purport to exhaust the issues on which there is vociferous disagreement. Rather it brings into relief those conflicts on which it seems that a decision will have to be taken one way or the other, leaving out theoretical alternatives which, for practical reasons, stand little chance of implementation.

It is the purpose of this paper to suggest that on the real bread-and-butter issues the opposing positions are not as irreconcilable as they seem, and that a solution can be devised which allows each party to hang on to its pet idea, while at the same time permitting gradual progress towards a saner international system to which no party can rationally object. (With one proviso—the proposal would not in itself solve the problems of chronic exchange shortage of the underdeveloped countries, in the manner, for example, of the various Stamp Plans.)

There is, of course, an element of arbitrariness in deciding which are the "real" or "practical" controversies to which the discussion should be narrowed down. It might be as well, therefore, to set out the underlying assumptions, both with regard to alternatives to be dismissed as unrealistic, at least in this decade, and with regard to the direction in which the international monetary system is likely to evolve in the long run.

The Alternatives

To begin with the latter, a plausible case can be made that international money is passing through the same stages as national moneys, with a lag of anywhere from 50 to 150 years. Domestically, money

evolved from being full-bodied, through representative and fiduciary, to book-entry money. (I have avoided the more commonly used term "deposit money" for three reasons: to keep clearly in sight that even today most "deposit money" is the result of credit creation rather than of cash deposited; that with increasing computerization even the "deposits" of individuals will increasingly result from the direct transfer of incomes to the individual's bank account, without any actual deposit of cash, checks, or other tangible credit instruments; and to allow for overdrafts, as already employed in the banking practice of other countries.)

Internationally, the gold-exchange standard represents the counterpart of representative money. What today's controversy is really about is (1) whether an attempt should be made, through appropriate adjustments, to make this present system of international representative money serve longer, either by restoring confidence in the key currencies (and possibly increasing the metallic base through a rise in the price of gold) or by enlarging it into a multiple-currency-reserve system; or (2) whether we might move on to the fiduciary stage, either gradually or by cutting the umbilical cord with gold once for all, making the dollar, probably also sterling, and perhaps eventually one or two other moneys true international reserve currencies, independently of any gold convertibility; or (3) whether we could jump straight over the fiduciary stage and establish international credit money.

Two further alternatives, it will be noted, have been left out. (1) Going back to a pure international gold standard: assuming, for the sake of argument, that such an animal ever existed after the rise of industrialism and international specialization, this would be such a retrograde step that it is hard to credit that even many Frenchmen can be serious about it. And (2) flexible exchange rates: for all the recent academic interest, they are plainly unacceptable to central bankers and men of affairs. Whatever the merits of flexible rates, they will therefore not be considered as a presently practical alternative—and here the element of arbitrariness admittedly creeps in.

We are thus left with the three practical possibilities enumerated above. And this is the time to spell out the second underlying assumption. Few of us can doubt that the world at large, like national entities before it, is moving towards a system based largely on credits and debits in the books of banks. But it is the writer's contention that the world is not yet ready for it. Something like Keynes' Clearing Union or the Triffin Plan is not only the most rational solution, it will also, in time, be seen as such by everybody (well, almost everybody) and be adopted. But two factors militate against its early adoption: "*natura non facit saltum*," and bankers and the general public do so even less.

Yet, after all, bankers must operate the system, and the money must be acceptable to the public. Moreover, there is another objection: for all the ingenious safeguards devised by Triffin (for example, that open-market operations of the XIMF be undertaken only with the consent of the governments concerned, and that the annual increase in credit might be agreed upon *a priori*), it cannot be denied that national governments would have to abdicate at least part of their monetary sovereignty; and this simply is not in the cards before the nations are ready to give up at least part of their political sovereignty. If today the countries of the EEC are not even close to adopting a common monetary policy, let alone a common currency and central bank, how can one seriously expect that a super-central bank will be acceptable to a hundred-odd sovereign countries?

The Evolution of International Money

The world needs an international currency. If the time is not yet ripe for "bancor" or some similar internationally created unit, then either gold or one or more national currencies must, for the time being, serve this purpose. The case against gold, either in the guise of a pure international gold standard or as a fixed fractional reserve against outstanding liabilities, is overwhelming: Either the minimum-reserve ratio would have to be set so low as to be entirely unsatisfactory to the Continental gold enthusiasts, or the price of gold would have to be raised recurrently—and the obvious undesirable consequences of such a procedure are too well known to require elaboration. Equally well understood today is the fact that the so-called international gold standard of the 19th century was for practical purposes a sterling standard. To be sure, sterling was convertible into gold; but while the Bank of England's fiduciary note issue was rigorously limited, there certainly was no mechanistic limitation of "sterling liabilities to foreigners" to any fixed multiple of the Bank's gold reserves. Fortunately, perhaps, neither the Bank nor the Board of Trade had shown enough ingenuity to develop our modern, sophisticated liquidity concept, and thus Continental bankers could sleep peacefully.

For twelve years after World War II, the world was unambiguously on a dollar standard; the gold convertibility of the dollar was incidental and irrelevant. Only since 1958 have we had this hullaballoo about a dollar crisis, and the plethora of admonitions that we "restore equilibrium," that the further creation of reserve assets in the form of increased dollar balances is unacceptable and must be stopped as soon as possible, and that, if necessary, additional international reserve assets must be based on the inclusion of French francs, Deutschemarks,

and other hard currencies (in addition, perhaps, to larger IMF quotas and drawing rights).

To seek refuge in a multiple-currency-reserve system (while simultaneously halting the further accumulation of dollar and sterling balances) may seem an attractive solution. But it has at least two serious shortcomings. For one thing, either the choice of key currencies to be held as foreign-exchange reserves is left to each country's central bank, in which case, as Professor Machlup has remarked, we seem to have forgotten the painful experiences with bimetallism and the more recent periodic rushes of short-term capital in and out of gold, dollars, and sterling, and are prepared to compound the trouble by adding a few more permutations; or the distribution as among reserve currencies is rigidly fixed, in which case we are back to the endless bickering whether there is too much or too little liquidity, who shall determine periodic increases in reserve assets, and how. Moreover, there is an equally strong second objection to such a "solution." Sterling in the 19th century, and the dollar in the 20th, did not become key currencies by accident, or arbitrarily. To use a convenient terminology, they came to be widely accepted as "reserve currencies" because they had established themselves as international "vehicle currencies"; not only were the United Kingdom and the United States principal trading nations, but even trade among third countries was financed through London and New York, and so were capital transactions.

Little has changed in that situation, except that New York and London have reversed positions. The large majority of commercial transactions are still financed in dollars and sterling, and the narrowness of capital markets other than New York and London is notorious. In these circumstances, to elevate, say, the French franc by fiat to the status of a reserve currency, solely on the ground that France has managed to keep its currency "hard" for fully eight years, is so artificial as to be ludicrous. Nor is there any indication that the Germans or the Swiss are anxious to see their currencies used more widely outside their borders, and thus outside their control.

Similar considerations militate against relying on reserve creation through the IMF as an adequate solution. Two schemes of this kind (not necessarily mutually exclusive) are being canvassed: the extension of quasi-automatic drawing rights of the gold-tranche type, and the issuance of reserve units by a Fund affiliate, membership in which would be open to all Fund members.

Additional drawing rights could be provided within the existing framework of the Fund's Articles of Agreement. This institutional continuity would be a great advantage, both because it should make it easier to implement the scheme, and because familiarity with the concept of

drawing rights as well as experience gained in the Fund over the past 20 years should ensure smooth operation. As a broadening of the Fund's role the scheme deserves wholehearted support. Yet it would not be much more than restoring the *status quo ante*: the totally unforeseen rate of growth in world trade has increasingly hampered the Fund in fully playing the part originally envisaged for it; by granting additional drawing rights the Fund would simply catch up with the volume of trade that needs to be financed—even if it is agreed that the Fund's resources need not be related to the absolute volume of trade, but only to the amplitude of fluctuations in it.

In principle, of course, drawing rights could be increased to any amount considered desirable by the most expansion-minded members. But experience in connection both with the last increase in quotas and with the negotiations leading up to the General Arrangements to Borrow must convince even a determined optimist that whatever agreement can be hammered out is more likely to err on the side of caution and conservatism than otherwise. Nor should it be forgotten that even at the outset of the Fund's operations, when its resources seemed much more adequate than today to cope with normal balance-of-payments fluctuations (once reconstruction had been accomplished), the existence of the Fund did not dispense with the need for using the two key currencies. Nothing that has happened since suggests that even greatly increased drawing rights could be a *substitute* for rather than a *supplement* to other forms of international liquidity (also in increasing amounts). As will be argued below, central bankers do not seem prepared to consider drawing rights—lines of credit—a satisfactory substitute for owned reserves.

The second scheme—creation of Fund reserve units—raises difficulties of a somewhat different sort. In the first place, these reserve units would be issued not by the Fund itself (where foot-dragging by the more conservative-minded members would effectively stymie creation of anything like an adequate amount) but by an affiliate of the Fund. This surely is a step in the right direction, if the scheme is to get off the ground at all. It also means, though, that Fund members that do not participate in the scheme might be unwilling to accept Fund units in payment of debts. As long as one or more surplus countries refused to participate, little would be changed from the present situation where they are reluctant to hold dollars. In fact, however, additional complications would arise. Transfers of Fund units would (to quote from the IMF's 1966 *Annual Report*) "be subject to an element of guidance" in order to avoid "the necessity for countries in balance-of-payments difficulty having to accept transfers from other countries and [to bring about] a general proportionality between holdings of the new reserves

and other forms of reserves." In plain English, there are three jokers in the deck: it is openly recognized that at least some countries would not treat Fund units as fully interchangeable with other reserves; prior agreement has to be reached concerning the proper proportions in which Fund units and other reserves are to be either held, or accepted in payment of debts—and it appears at least doubtful whether such agreement would be easier to reach than agreement about the mode of implementing the Posthuma Plan or any other multiple-currency-reserve plan; and by submitting to the "guidance" of the Fund affiliate, central banks would be deprived of the freedom to distribute their reserves according to their respective preferences as among presumed safety, presumed liquidity, and earning power. (Should, for example, Japan be compelled to hold a larger proportion of its reserves in gold than at present, in order to conform to the compromise proportion?)

Finally, another doubt creeps in. The existence of an international gold-exchange system dates from the discussions at the Genoa Conference of 1922. What persuaded so many countries to add sterling and dollars to their gold reserves was the wide use of sterling and dollars as international trading currencies. The proposed new Fund units, on the other hand, are specifically to be held and used by monetary authorities only. This sharp separation of the reserve-currency and vehicle-currency aspects of international money constitutes a much sharper break with the past than, say, a revaluation of gold or further extension of the key-currency system. This is not to suggest that such a separation of functions is impossible; but the break in continuity should certainly be taken into account, not only in considering the probable reaction of bankers and traders but also in thinking through the implications for monetary policy. In any event, though, the need is not alone for increasing official reserves but also for increasing private cash balances of some kind of international money. Even if early agreement could be reached on the creation of official reserves—and it is a big "if"—the writer must admit to considerable doubt whether such Fund units (as currently envisaged) could ever become a fully satisfactory substitute for gold or key currencies.

No, on this count Roosa is right: the obvious solution lies in adapting and evolving the present system (to paraphrase Lord Butler's delicious barb, it is after all the best system we have), at least until a new generation of bankers and a better-educated public are ready for a system of centralized reserves and/or international credit creation. For the foreseeable future, the dollar will not only have to remain the primary reserve currency of the free world but any need for increases in inter-

national reserve assets, over and above newly mined gold, will have to take the form of increased foreign dollar balances.

European Objections

And what about the opposition to this idea from the Continental Europeans? Do we not first have to balance our international accounts and restore faith in our currency by overcoming the "dollar crisis"? The "dollar crisis" is a sham and a delusion. We have allowed ourselves to become the victims of misinterpretation by Europeans of our balance-of-payments presentation. What this presentation obscured (quite apart from the asymmetry in the treatment of private short-term credit) is that, as Messrs. Despres, Kindleberger and Salant have argued so convincingly in the *Economist* (of February 5, 1966), the United States has become the world's financial intermediary, borrowing short and lending long. As the most cursory glance at the balance of international indebtedness of the United States will show, this country's overall financial position vis-à-vis the rest of the world, far from weakening, has been growing stronger year by year. Add to this that, through all the years since the so-called dollar crisis was first proclaimed, the dollar's purchasing power has remained relatively more stable than that of any other currency, and it becomes easy to understand why not only nonofficial foreign dollar balances have continued to grow—certainly from choice, not as a result of U.S. Government "persuasion"—but also why a number of countries—Canada, Japan, Sweden, for example—have elected to hold on to large dollar reserves, apparently more impressed by facts and figures than by the hue and cry raised in some Continental places. And, unless we manage our economic and financial affairs less well than we have in the past five years, there is little reason to believe that non-European governments as well as international traders and private banks will in future be any less willing to hold interest-earning dollar assets. On the contrary, as long as world trade expands, and as long as a large proportion of it is financed with dollars, the needs of foreign traders and bankers for dollar balances will grow.

This leaves certain European governments and central banks that might be unwilling to accumulate any further dollar balances, and might even wish to convert part or all of their existing ones. But this need hardly be a problem for the United States, even today. Total liabilities to Western European official institutions (including U.S. Government marketable securities of more than one year original maturity, though excluding nonmarketable U.S. Treasury notes and bonds) have long been hovering around $7 billion. Of the countries that have shown an inclination to convert a large part into gold, only Italy, West Germany, and Switzerland (with total balances—official *and private*—of between

$1.5 billion and $2 billion each) and France (with $1 billion) are of any importance. Of the other countries of the new "gold bloc," Belgium holds only approximately $350 million, and the Netherlands approximately $300 million in dollar balances—official *and private.* It follows that the United States could easily satisfy the demands of all of them, even if they chose to convert their entire official dollar balances into gold. In fact, the United States might well encourage them to convert to their hearts' delight, thereby removing a perennial cause for complaint and clearing the decks for a new initiative. (To reassure the remaining dollar holders, however, explicit guarantees—exchange guarantees or foreign-denominated bonds—may have to be offered. We shall discuss this later on.)

Establishing A Dollar-Reserve System

This new initiative would look to the firm establishment of the dollar as the chief international reserve currency, on a voluntary basis, that is, for all countries that wish to be included in the system. The first opportunity to do so and thereby rid the world's monetary system of the shackles of gold (as had already been done for national monetary systems in the 1930's) was missed in the years 1945-1957—partly from lack of foresight and imagination, and perhaps partly also because the public in the United States was still too strongly wedded to the gold link. We have learnt our lesson, but we may temporarily have lost the initiative. After seven years on the defensive psychologically, the moment may not be propitious for the necessary steps to be initiated—even though the "weakness" of the dollar is apparent rather than real. But under no circumstances must we let the next opportunity slip by. It seems reasonable to assume that with fixed exchange rates there will continue to be alternating periods of "strength" and "weakness" (on a liquidity basis) for the dollar, as there have recently been for the Deutschemark, for the lira, and for the guilder. (Nor can France expect to escape the ebbs and flows in international payments. The history of the French franc between 1926 and 1938 ought to serve as an awful reminder to France's money managers, who at the moment seem to be riding the crest of the wave just as cockily as they were in 1931.)

In the United States we seem to be stuck, for the time being, with the liquidity concept of the balance of payments, the Bernstein Report notwithstanding. To be satisfied with a zero deficit on the "basic balance" or the "official-settlements balance" might too easily appear as fiddling, and therefore might not be a solid enough basis from which to launch the transition to an international dollar-reserve standard. American policy-making should therefore be two-pronged: for the short term, measures to overcome the balance-of-payments deficit on *any* definition,