ESSAYS IN INTERNATIONAL FINANCE

No. 87, July 1971

TOWARDS NEW MONETARY RELATIONSHIPS

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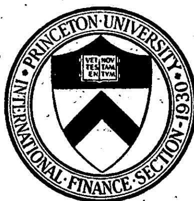

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This is the eighty-seventh number in the series ESSAYS IN INTERNATIONAL FINANCE, *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

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PETER B. KENEN, *Director*
International Finance Section

Re. *Towards New Monetary Relationships*, by Rinaldo Ossola,
Essays in International Finance No. 87.

ERRATUM

On page 17, the quotation just before the subheading should read: ". . . the best alternative to a system of fixed rates with provision for increasing liquidity would, in our view, be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc. There would be relatively fixed rates within each bloc and flexible rates between them. Adoption of this system would imply cutting the tie between gold and the dollar." (*The U.S. Balance of Payments in 1968*, p. 259).

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Department of Economics
Princeton University
L.C. Card No. 72-168760

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

TOWARDS NEW MONETARY RELATIONSHIPS

This essay tries to explore the possible impact that certain decisions (some taken in the course of the last few years, others likely to be taken in the not too distant future) may have on the evolution of the international monetary system. It gives special attention to the monetary relations between the United States and an enlarged European Economic Community (EEC), and between these and the emerging countries. An attempt has been made to express these issues in the framework of the established order of the International Monetary Fund (IMF).

The international monetary system, as it works today, can truly be said to be centered on the IMF. It is characterized by the following essential elements: (1) complete nondiscriminatory freedom of current payments and transactions; (2) the discretionary power to control capital movements provided the freedom of current payments and transactions is not prejudiced (member countries have less and less availed themselves of this power, especially after 1958, when external convertibility was reestablished by most of the industrial countries); (3) stable parities, fixed in terms of gold at realistic levels and in agreement with the IMF; (4) par values, which in case of fundamental disequilibria can be adjusted after consultation with the Fund and, normally, after the Fund's concurrence; (5) fluctuation of exchange rates which for spot transactions can vary within 1 per cent on either side of the par value—a limit which may be exceeded, but only to a reasonable extent, for forward transactions.

In general, the currencies of all Fund members have been put on an equal footing. The U.S. dollar, however, has obtained a special status as the result of various factors which have led to its establishment as the main currency in which international trade is transacted, in which international reserves are held, and which central banks employ when intervening in the foreign-exchange markets to stabilize their own currencies. The IMF requirement that currencies not deviate by more than 1 per cent from their official par values in terms of gold or, in practice, the dollar has the logical result that related currencies, such as those of the EEC countries, can diverge from one another by as much as 2 per cent (when, for example, currency A appreciates by 1 per cent relative to the dollar while currency B depreciates by 1 per cent relative to the dollar).

Therefore, it is technically possible under the IMF rules for the "fixed" exchange rate between two EEC countries to change by up to 4 per cent (as currencies A and B exchange their positions at the limits of the narrow band around their dollar par values).

However, all the EEC countries and almost all the OECD (Organization for Economic Cooperation and Development) countries keep their margins of fluctuation vis-à-vis the dollar within 0.75 per cent. Consequently, the exchange rate between two EEC countries can change up to 3 per cent, that is, intra-EEC exchange-rate fluctuations can be twice as large as those vis-à-vis the dollar. Moreover, parity regulations among the EEC countries are stricter than those of the Fund. According to the Rome Treaty, each country must consider its own exchange-rate policy as a matter of common interest and, according to a decision taken in 1964, prior consultation among member countries is required if a country wishes to change its par value. (Consultations under these agreements took place in August and October 1969 on the occasions of the devaluation of the French franc and the revaluation of the Deutschemark.)

The above has special significance, in view of the fact that historical experience shows that the development of a common-trade area inevitably leads to a common-currency area. Vagaries of exchange-rate differentials affect price differentials, leading to competitive advantage and disadvantage related not to market or quality conditions, but to differences in monetary values beyond the producer's or trader's control. The history of the United States, which may be said to have been an antecedent of today's common-trade areas and integrated markets, shows how pressure from economic forces eventually leads to monetary unity. Even though the various parts of the United States were all joined through the gold dollar as the common currency, up to the time of the Civil War, there were wide differences in the costs of transfer of funds—either because notes issued by state banks circulated at varying values, depending on prestige or risks, or because the time element in the shipment of funds led to considerable escalation of interest rates between the financial centers and the rest of the country. A major factor in the introduction of a "national" banking system a century ago was a recognized necessity of introducing a uniform currency that would command acceptance and prestige and maintain a single par value throughout the nation. This, however, still did not alleviate the differential cost of shifting banking funds (through drafts or checks) subject to commissions and of changes related to the time element involved in their transfer. For this reason the Federal Reserve was charged, from its establishment, with the task of providing "exchange at par" for banking trans-

fers throughout the nation. The experience of the United States would seem to show that exchange-rate differentials, small as they may be as a marginal price factor, have a larger impact on business profits, which is sufficient to bring pressure for their elimination in order to strengthen economic ties through greater efficiency and lower cost in the movement of financial and real resources.

EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

The International Monetary Fund has a significant influence on the monetary relations among its 117 member countries (almost the entire international community with the exclusion of most socialist countries). The Fund has indeed been able to shape its objectives in accordance with the changing demands of the last 25 years and today it is undoubtedly an instrument fully capable of coping with the significant developments that are in the making. Actually, since Bretton Woods, the international monetary system has been integrated with new instruments which are either directly linked with the Fund or make the Fund more effective by supplementing the temporary assistance it provides to countries in balance-of-payments difficulties. Here are some examples: (1) the General Agreement to Borrow, whereby the major industrial countries have extended to the Fund credit facilities amounting to 6 billion dollars, thus relieving pressure on the Fund's own resources; (2) reciprocal monetary arrangements for lines of credit ("swaps") between the Federal Reserve Bank of New York and the central banks of the major countries, which now amount to well over 11 billion dollars; (3) the establishment, in case of need, of regional credit facilities for the defense of important currencies other than the dollar; (4) short-term-credit arrangements among the EEC central banks for a total amount of 2 billion dollars; and (5) the Fund's compensatory financing and buffer-stock arrangements for the needs of the emerging countries. If one adds all these facilities to the Fund quotas, now increased to over 28 billion dollars (or over 10 per cent of the annual exports of all countries), it is possible to judge the strength of the defenses which protect the system against temporary excess of countries' payments for imports over earnings from exports, and from all but the worst speculative movements of money between countries.

While these enlargements of sources for supplementing countries' holdings of foreign-exchange reserves are important, they have not been considered sufficient. Other measures have been taken, or are under consideration, which will provide further evolutionary impulses to the system. The changes include:

(1) the creation and subsequent activation of Special Drawing Rights

(SDRs), whereby the principle has been introduced that the reserve assets needed to cope with the long-term need for unconditional international liquidity must be created by deliberate action and in a non-inflationary way, rather than as a result of gold mining or of payments deficits of the United States;

(2) the Washington Agreement of March 1968, which sanctioned the separation between monetary gold and gold as a commodity, as well as the December 1969 agreement between the IMF and South Africa, which, although it reduced the degree of separation, established that newly-mined gold will enter into official reserve holdings on the basis of Fund decisions;

(3) a development that may have a great significance is the decision taken on December 1969 at The Hague by the Community heads of state and of government aiming at creating within the next ten years an Economic and Monetary Union. (Negotiations for admission into the EEC of the United Kingdom and of other candidate countries have been resumed in recent months, after the fruitless efforts of 1964. These now have much better chances of success as a result of both a softening of certain national positions within the EEC and a more decisive political will on the part of the applicant countries.);

(4) of major significance for the mechanisms of international trade, the proposals aimed at introducing into the international monetary system a moderate degree of exchange-rate flexibility, as indicated in the September 1970 Report of the Executive Directors of the Fund.

These are the most meaningful innovations that can deeply transform international monetary relations, albeit with the gradualism necessitated by political considerations, especially when the transformations imply the transfer of powers and responsibilities from the national to the supranational sphere. The International Monetary Fund will continue to be the indispensable moving force in this evolutionary process; its relations with individual countries will gradually be replaced by relations with groups of countries, free-trade areas, and economic communities—that is, with monetary areas wider than the present boundaries of a state.

Further evolutionary impulses to the system will also come from the following developments: the increasing interdependence of national economies stemming, *inter alia*, from the acceleration of technological progress and from the numerous transnational mergers of major corporations and banks; the increasing influence that economic policy decisions taken by one country, especially if it is a major one, exercise on other countries; the accelerating expansion of the Eurodollar market where important internal multiplier effects are becoming increasingly evident. These developments, combined with the continuous rise in

private-sector financial assets, have greatly increased the interest sensitivity of capital, further complicating the adjustment process.

FUTURE ROLE OF SDRS

When considering innovations, one should begin with the Washington Agreement of March 1968 and the creation of SDRs. These two events have set in motion an irreversible process whereby the monetary system departs from the "gold-exchange standard" by gradually reducing—and eventually eliminating—the monetary function of gold in the system and tending to diminish the reserve role of the dollar.

During the last decade the share of gold in total reserves has continuously decreased, since almost all newly-mined gold has been used to meet industrial needs and other demands. Accordingly, monetary authorities have tended to use less and less gold, with external disequilibria being financed mostly by selling foreign exchange, activating swap arrangements, and utilizing Fund Reserve Positions and Fund credit facilities. Gold has been sold only as a last resort—a somewhat paradoxical end for what has traditionally been considered the most liquid reserve asset.

To the extent that SDRs gradually become the main source of liquidity for the system, as well as the largest reserve component (such a situation should materialize within 10 to 15 years, if SDRs continue to be created at the present rate), and to the extent that prices continue to increase, monetary gold will decrease in relation to goods and services. This contraction should not be compensated for by increasing the official price of the metal, but by creating SDRs in the amounts needed for international trade and transactions.

In the longer run, as industrial uses inevitably grow, equilibrium between the demand for and supply of nonmonetary gold could thus command increasingly higher market prices, up to the point where the difference from the official price would induce amendment of the Washington Agreement, allowing monetary authorities to finance balance-of-payments deficits by selling gold directly on private markets. The anticipation of such profits on sales of gold might seem to be an inducement to central banks to hold on to their gold stocks or to acquire more gold on the free market. However, the expectation of an increase in the long-term price of gold on the private market may not lead to such behavior, because the expected earnings from the interest income obtainable from foreign-exchange holdings or SDRs may be higher. In other words, if SDRs continue to be a valid instrument, the monetary system will have truly been endowed with a superior substitute for gold.

The experience of the facility's first year is very encouraging. Under

Fund surveillance the great majority of members that have utilized SDRs have done so in an appropriate and prudent way. For the evolution towards reliance on SDRs as the expanding reserve component to take place—which I believe would be highly desirable—it is necessary that the monetary authorities continue to have faith in the validity of this new instrument. Especially, they must trust that SDRs will meet the global, long-term need for international liquidity in a rational manner, that is, independently from events such as gold production and balance-of-payments deficits which have little or nothing in common with these needs. Unlike gold and dollars, the creation of SDRs is under international control, and international liquidity can be increased without resorting to destabilizing changes in the price of the reserve instrument. Furthermore, SDRs are the only instrument whose production does not absorb real resources. One must point out, however, that among European monetary authorities the conviction is spreading that there should not be a second activation of SDRs in the near future (or, at least, any such activation should be very small, not to say symbolic). This conviction stems from the considerable increase which has taken place in official dollar reserves during 1970, an increase which is moreover considered likely to continue in 1971.

These are of course complex issues, which those who determine the amount of new SDRs will have to face. One question is whether the need for international liquidity should be measured on the basis of net rather than gross reserves. For example, an increase in reserves in the form of official holdings of dollars has its counterpart in a deterioration of the American liquidity position. (Holdings of SDRs, gold, and so forth, by the United States may be unchanged, but its liabilities to other governments in the form of dollars—liabilities which it may be obliged to pay off with gold or SDRs—may have increased.) Even if gross reserve assets should be the correct concept, a grant of SDRs would not necessarily raise gross reserves of the United States; instead, it might induce reluctant holders of dollars to oblige the United States to use up some of its newly-allocated SDRs to buy up some of those undesired dollars.

The preceding discussion has assumed that SDRs will succeed in establishing themselves as a major component of international reserves. It was indicated above that there is some opposition to this belief. However, the success of the anti-SDR thesis, which could be facilitated by the persistence of large American deficits, would indeed be a calamity. Paradoxically, for a time it would even cause the establishment of a dollar standard, because central banks would be forced to accept the surplus dollars offered by the United States in payment of her deficits.

In that eventuality, two hypotheses are possible. The first is that gold would again become, although only temporarily, the basis of the system; and for gold to serve this purpose its price would have to be raised. However, because gold does not yield interest, reserves would very soon tend to be converted back into a credit asset—most probably dollars. We would then have come full circle, and there is general agreement that it is always better to run straight than in the best of circles. It is not difficult to forecast that in such circumstances recurring crises would affect the major currencies.

The second hypothesis is that gold sales might be suspended by the U.S. Treasury, owing to massive conversions by foreign monetary authorities. The consensus is that, if the United States were to take such a step towards a *de facto*, if not indeed a *de jure*, dollar standard before the European countries had made substantial progress on the road to monetary union, it would almost certainly induce conflicting reactions among the EEC countries. This would set in motion a process of disintegration within the Community, which would soon require the imposition of severe exchange controls. A long period of monetary disorder, similar to that which characterized the twenties and the thirties, would thus begin.

For these reasons, one must hope that the anti-SDR thesis will not succeed, although one cannot exclude the possibility. Even in the early stages, the smooth continuation of the SDR system, especially if holders of this asset were to be rewarded with an interest rate higher than the present 1½ per cent, would have the advantage of increasing the desirability of this asset. While this would mean that the role of the dollar as a reserve currency would be progressively reduced, it would also imply that the dollar could keep the function of an intervention currency (possibly together with the other intervention currency that might emerge from the European Economic and Monetary Union) and would increase its role as a vehicle currency.

ECONOMIC COOPERATION WITHIN EUROPE

Economic and Monetary Union

The second order of events liable to affect deeply the structure of international monetary relations in the near future is represented by The Hague decisions of 1969, the Werner Plan and the EEC Commission proposals, in addition to the beginning of the negotiations for the admission of the United Kingdom into a rapidly changing Community.

The final objectives of the Economic and Monetary Union can be briefly summarized as follows: free movement of labor, trade, services

and capital so that economic objectives can be pursued on the EEC scale rather than at narrower national levels; full, irreversible currency convertibility; elimination of intra-EEC margins of fluctuation; irrevocable fixing of intra-EEC par values in order to reach the *de facto*, if not the *de jure*, creation of a single currency to be jointly managed by the Community central-bank system; transfer from the national states to the Community of responsibility over economic matters such as the state budget and the budget of the rest of the public sector, internal liquidity, credit policies, the capital market, external monetary policy, and regional and structural policies. The transfer of economic responsibilities from the states to the Community presupposes that the center of decision-making (which is likely to be the Ministerial Council at first, and the Commission later) will be politically responsible to a democratically elected European Parliament. A refusal to make such political choices by considering them utopian may lead to an even more dangerous utopianism, namely, that Europe can be built by means of a few clever technical schemes. Saying that one should begin directly with the first phase of the work without worrying about the institutional problems and political decisions involved is as realistic as beginning a long and costly trip without knowing the destination.

The first phase of the realization of the Union should begin as soon as the EEC Ministerial Council takes a decision on the Commission's proposals. The first meeting took place in mid-December 1970 and the second one was held in early February of this year; the views which were exchanged among the EEC financial ministers and central-bank governors in connection with the recent Arnhem meeting give rise to some optimism about the final outcome of the negotiations.

The first phase will last three years and will cover events of great moment, such as:

(1) reduction of fiscal barriers within the Community (lessening of differences in tax rates and of the rates of value added and excise taxes, harmonization of tax rates and the tax base applicable for fixed-income financial assets and dividends, harmonization of corporate taxes, complete lifting of controls on intracommunity travel);

(2) free circulation of capital within the Community (introduction and gradual increases in the maximum sizes of bond and stock issues that private and public enterprises of one EEC country can make in another EEC country, quotation on the stock exchange in one or more EEC countries of stocks and bonds issued in another EEC country, abolition of residual exchange controls within the Community);

(3) strengthening of the coordination of short-term economic policies,

especially budget policy in the framework of guidelines set out for medium-term economic policy;

(4) progressive adoption of common positions in economic relations with countries outside the Community and with international organizations. In particular, as a rule members should not avail themselves individually of any greater flexibility of exchange rates that might be introduced into the international monetary system;

(5) during the first phase, members should accept a small and experimental reduction of the fluctuation margins of their currencies, that is, intra-EEC margins should be narrower than those resulting from the application of margins stipulated vis-à-vis the U.S. dollar.

As regards the latter point, it would be very advantageous, at least during the first phase, to have a widening of the margins of variation in the rate of exchange established with the intervention currency (the dollar)—for example, from the present ± 0.75 per cent to the full 1 per cent permitted by the present Fund Articles. This widening of exchange-rate variability vis-à-vis nonmembers of the EEC would accompany a reduction of the intracommunity margins (for example, from the present ± 1½ per cent to ± 1 per cent). On the one hand, this would also contribute to the objective of further differentiating the Community system of exchange rates vis-à-vis the dollar, a clear reversal of the present relationship of the EEC currencies to the dollar. On the other hand, it would have the merit of still allowing the monetary authorities of the EEC a margin for maneuver, which recent events have indicated might be quite useful.

Success in meeting this double requirement—each member currency being permitted to diverge from its par with the dollar by no more than 1 per cent but also being limited to a divergence of no more than 1 per cent from its par exchange rate with any other member currency—will require closer intra-EEC cooperation. In practice, the daily management of members' dollar exchange rates would be coordinated by central banks defining the so-called "Community level" of the dollar. The price of the dollar in each of the markets of the Community would not be allowed to deviate from this level by more than a percentage equivalent to half the width of the fluctuations allowed for the Community currencies. The band between the upper margin and the lower margin would fluctuate between the absolute limits applicable to the dollar according to the fixing of the "Community level." Thus, if the EEC decided on an average of ½ per cent appreciation above dollar par values, a member country would be permitted to fix its dollar rate anywhere between the par level itself and a level that was appreciated 1 per cent above par.

One should not minimize the difficulties that might arise in obtaining