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AN AGENDA FOR MONETARY REFORM

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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An Agenda for Monetary Reform*

The agreement reached in Washington on December 18, 1971, dealt with two important matters. It provided a breathing spell by realigning the rates of exchange among the currencies of the major industrial countries and widened the margins within which the market rates were allowed to fluctuate around the new "central rates" or informal parities to 2.25 per cent on either side of the central rate.[1] However, most of the questions pertaining to the structural reform of the international monetary system that was finally rendered unavoidable by the American measures of August 15, 1971, were deferred. A communiqué announced:

> The Ministers and Governors agreed that discussions should be promptly undertaken, particularly in the framework of the IMF, to consider reform of the international monetary system over the longer term. It was agreed that attention should be directed to the appropriate monetary means and division of responsibilities for defending stable exchange rates and for insuring a proper degree of convertibility of the system; to the proper role of gold, of reserve currencies, and of Special Drawing Rights in the operation of the system; to the appropriate volume of liquidity; to re-examination of the permissible margins of fluctuation around established exchange rates and other means of establishing a suitable degree of flexibility; and to other measures dealing with movements of liquid capital.

Before detailed official discussions on these subjects begin, it may be useful to take an over-all look at them here, with special attention to their interconnection.

History Repeats Itself

The successive monetary systems have come into being mainly by a process of spontaneous evolution, and without purposeful direction and decision aimed at deliberately creating the system on the basis of a well-defined plan. This is evident even from the most summary look at history.

* This essay is a version, revised in the spring of 1972, of a paper read on February 23, 1972, in New York at a seminar of the United Nations Institute for Training and Research. It is based in part on the active thinking that has been going on in recent months, and is still going on, within the International Monetary Fund. This thinking and these discussions have not yet led to firm positions and convictions; for this reason, the exposition does not attribute specific suggestions to specific persons. The author, too, wishes to stress the provisional nature of his views as set forth here.

[1] Since the monetary price of gold was increased to $38 per ounce in terms of dollars, but decreased in terms of other currencies, the average gold price remained approximately unchanged.

The gold standard emerged from a series of partial decisions in different countries, with no considered agreement on the question of whether gold, silver, or bimetallism should serve as the basis of the world's monetary system. The establishment of the gold standard in England, which led the way, was influenced decisively by the failure of a series of measures, inadequate in the light of Gresham's Law, to retain *silver* rather than gold as the standard metal. After the principal European countries moved to the gold standard shortly after 1870, largely as a matter of prestige, the debate on whether bimetallism was not after all preferable to gold continued until about 1890, when the discovery of the rich gold mines of Transvaal put an end to the prevailing gold shortage and thereby to the debate. France, conservative as always in monetary matters, kept promoting the role of silver as much as the circumstances permitted, both domestically and in the Latin Monetary Union, where it occupied a predominant position. There was no official doctrine at all concerning regulation of the deposit money created by the commercial banks, although it increasingly dominated domestic money circulation. Indeed, the money-creating role of the commercial banking system was not generally recognized until the twentieth century. The financial management of these private banking institutions was based, for a long time, on rules of thumb developed in practice.

Nor did the gold-exchange standard, which succeeded the gold standard, stem from a deliberate decision to introduce such a system. It developed spontaneously toward the end of the nineteenth century, particularly in transactions between the European mother countries and the Asian colonies, where silver had remained predominant. To be sure, the League of Nations recommended the system for some years after 1922, while the United Kingdom promoted the role of the pound sterling as a reserve asset. But the enormous expansion of the gold-*dollar* standard after 1945 came into being quite spontaneously, parallel to the system designed at Bretton Woods, as a result of the postwar economic power of the United States and the concentration of 70 per cent of the world's monetary gold stock in that country.

The suspension of the convertibility of the dollar into gold on August 15, 1971, together with the Washington agreement of December 18, 1971, on the realignment of exchange rates, to be maintained for the time being by means of official intervention with inconvertible dollars, has now ushered in the full-fledged dollar standard.

The fact that we have arrived at the dollar standard as the result of a temporary and partial solution of a problem is no reason to underestimate the importance of this development. After his thorough study of the development of the gold standard, Mertens (1944) concluded:

> It has definitely been one of the most tenacious illusions of the authorities to believe that by postponing final decisions and by resorting to temporary and emergency measures, they were preserving their freedom of action for the future. But we have repeatedly noted, on the contrary, that the authorities, in so doing, found themselves being carried along by these temporary measures in a development that led to results which they had by no means expected or wanted.

We should by no means exclude the possibility that we shall now once again witness this oft-repeated phenomenon. But neither may we exclude the possibility of exerting a positive influence on the evolutionary process. There exists today a widespread understanding of the interrelationships of the present problems of the international monetary system, as well as an institutional framework that makes possible intensive international consultation and cooperation. The establishment in 1969 of the Special Drawing Right (SDR) facility as a supplement to existing reserve assets and the creation and use of this new reserve asset during the first "basic period" 1970 through 1972 constitute a striking example of what can be achieved by constructive international collaboration.

Alternatives

Any attempt to turn back the clock and return to one of the previous systems runs counter to the nature of the evolutionary process. The *gold standard* belongs to the past. A return to it is not only impossible, it is undesirable. Given the responsibilities that governments everywhere have assumed for the course of their national economies, a linking of monetary policy to the quantity of gold that becomes available for monetary purposes—as the chance result of gold production, Soviet gold sales, and private, including speculative, demand for the metal—would be objectionable. The *gold-exchange standard* has just succumbed to the ailment that liquidity creation under that system undermines the financial strength of the reserve center—the pound in 1931 and the dollar in the 1960's and the beginning of the 1970's. The *dollar standard* is unacceptable. There is general agreement—shared by the U.S. authorities—that the international monetary order should not be based upon a single currency. Other countries would, to a large extent, have to follow U.S. monetary policy or protect themselves against the consequences of U.S. policy by changing their exchange rates and/or instituting exchange controls. Different countries might make different choices, so that we would get a dollar bloc with fluctuating rates and exchange controls between the currencies of the dollar bloc and the other main industrial countries. While such an outcome is by no means the most unlikely, it is, for rea-

sons more fully developed in the final part of this essay, definitely undesirable.

We shall therefore have to look for alternatives. In what follows, the outlines of one such alternative are sketched. As the scheme presented builds largely upon the SDR, it might be called an *SDR standard.*

Restoration of the Convertibility of the Dollar

The present difficulties were fully exposed by the suspension of the convertibility of the dollar into gold. A first question, then, is whether the system could be made to work again by restoring convertibility, that is, by returning to the gold-dollar standard. But, as already indicated, this is both impossible and undesirable.

It is impossible because it was precisely the steady erosion of the international financial position of the United States under the gold-exchange standard that forced the country to suspend convertibility on August 15, 1971. The U.S. gold stock amounts to no more than $10 billion; the dollar balances in foreign official hands alone amount to nearly $50 billion. The United States is broke and, as the Dutch saying goes, you cannot pluck feathers from a frog. The United States is no longer able to assure the convertibility of the dollar in its old form. It is conceivable in theory that the United States would be able to restore its financial position through an extended period of payments surpluses, and it would certainly be a mistake to assume that the U.S. balance of payments can show only a deficit. However, for a long time a U.S. surplus would lead only to a reduction in the dollar balances held as reserves by other countries, not to an increase in the U.S. gold stock. Moreover, it is unlikely that the other countries would put up with substantial U.S. surpluses continuing for years, since that would imply large and continuing deficits on their part. Besides, the imbalance between U.S. short-term debts and available assets would continue for a considerable period of time, in spite of American surpluses, so that it would in any case be necessary to come to an arrangement with respect to existing dollar balances in official hands.

A return to the gold-exchange standard is, moreover, undesirable. The system has proved to be unstable as a result of the simultaneous existence of a number of reserve assets, and the consequent incentives for destabilizing switches out of one asset and into another under changing circumstances. Efforts have been made to combat this instability by freezing exchange rates, especially those of the reserve currencies, with the result that the devaluation of both sterling in 1967 and the dollar in 1971 came years after they had become necessary, at great cost to the

balance-of-payments adjustment process. We shall come back to these problems.

In addition, a return to the gold-exchange standard would be a return to a system that does not permit of international control over the creation of international liquidity. Such control—one of the aims of the introduction of the SDR system, as reflected in Article XXIV of the Fund's Articles of Agreement—is thwarted under this system by the creation of liquidity in the form of the accumulation of dollar balances by other countries in the event of an American payments deficit, and the destruction of international liquidity in the opposite case. The enormous creation of international liquidity in 1970 and 1971 illustrates the point. In those two years, SDRs were allocated in the amount of $3.5 billion and $3 billion, respectively. The U.S. deficit, however, resulted in an additional creation of international liquidity of $8 billion in 1970 and of no less than $27 billion in 1971. Thus the actual increase in international liquidity far exceeded the planned increase.

The situation in which the United States can finance balance-of-payments deficits by providing its creditors with its own freshly printed dollars must end. But its counterpart must be that the United States receives payment in the form of reserve assets when in surplus and does not merely see its liabilities decline. Otherwise, the system is unacceptable to the United States in practice and unworkable in theory, since the United States would lose reserve assets when in deficit but would not earn any when in surplus, so that its reserve holdings could only decrease further.

Consolidation

Consolidation of existing dollar balances can eliminate the instability of the gold-exchange standard, permit control over liquidity creation, and allow the United States to earn reserve assets. In this connection, two matters must be clearly distinguished. In the first place, a *demonetization* of excess dollar holdings is called for. There are good reasons for assuming that the enormous rise in total international reserves during the last two years (from $78.2 billion at the end of 1969 to about $130 billion[2] at the end of 1971, a rise of more than 50 per cent) has led to an excessive supply of international liquidity. The demonetization could be effected by transforming these excess dollar balances into bilateral long-term loans to the United States. The rest of the dollar balances, representing a need for monetary reserves on the part of their holders,

[2] 120 billion if expressed in SDRs, that is, after correction for changes in value due to exchange-rate changes.

would be *turned over to the IMF in exchange for SDRs* to be created especially for this purpose.

These SDRs would have to have the same properties as the SDRs now existing, or, if changes within the new framework proved necessary (e.g., regarding the rate of interest or the rules concerning acceptance limits, designation, requirement of need, and reconstitution), these changes would have to apply to all SDRs. For we have to face the operation of Gresham's Law, this time in the international sphere, and it is therefore necessary to reduce the number of reserve assets.

It would be necessary to convert into SDRs not only all dollar balances, but also all official sterling balances and French franc balances, as well as official balances accumulated recently in other currencies. However, we shall no doubt come up against the problem that a rather sizable number of countries consider themselves so closely linked to either the U.S. or the British or the French economy that they will be unwilling to exchange their dollars, pounds, or francs for SDRs. This preference for reserve currencies is connected with the close relations maintained with the money-market and capital-market institutions in the reserve centers, with certain privileges regarding access to the capital market or development aid, and so forth. The management of their dollar reserves by New York banks, for example, provides some smaller countries with an introduction to those institutions that is of value to them when negotiating loans in New York on behalf of governmental or semi-governmental institutions. The same holds true for London and Paris.

Hence, although participation by all countries would be preferable by far, and would considerably strengthen the system, we may have to limit ourselves to an arrangement in which only the major trading nations take part. But their participation will have to be complete if a workable system is to be achieved.

Complete freedom as to the composition of their reserves would be impossible for the smaller countries as well; the operation of Gresham's Law is too pernicious to allow it. In the past, the weapon chosen to counter the prejudicial effect of conversion of one reserve asset into another under the operation of that Law has been to limit convertibility. This has been done for the sterling-area countries by means of agreements between them and the United Kingdom on the maintenance of a Minimum Sterling Proportion in their reserves, and has now been followed by the suspension of the convertibility of the dollar into gold. Hence, countries unwilling to exchange their dollar, pound, or franc balances for SDRs would have to acquiesce in an arrangement stipulating that their balances would in the future be converted into SDRs by the reserve center only for the purpose of covering actual deficits outside the dollar, sterling,

and franc areas, respectively, and not for the purpose of changing the composition of the reserves. Furthermore, countries choosing to continue to belong to a given currency area would have to bear the full risk (sometimes positive, sometimes negative) of changes in the par value of their reserve currency. As a consequence of these stipulations, the United States, the United Kingdom, and France would have to settle the balance-of-payments position of the entire dollar, sterling, and franc areas, respectively. For the sterling and franc areas, this is already the case.

Such a consolidation arrangement will have a chance of success only if there is willingness to consolidate. Seeing to it that the exchange of reserve currencies into SDRs does not result in a loss of interest payments received will foster this willingness. Hence, the rate of interest on SDRs should be increased; it should be harmonized with the yield obtainable in the principal reserve centers, New York in particular. In fixing the interest rate, account will also have to be taken of the advantage (or disadvantage) of holding reserve assets denominated in SDRs.

The working of Gresham's Law also makes it necessary to have a look in passing at the position of gold in the system. With the gold price on the free market much higher than the official price of gold, central banks will show great reluctance to part with their gold at $38 an ounce in official transactions. Gold reserves (and SDRs) thus become frozen, as monetary authorities try to pay in "bad money." This situation is unlikely to last indefinitely, however, and the central bank of a country in deficit will sooner or later be tempted to sell some of its gold on the free market and use the proceeds to support its currency. If this pattern were to prevail, gold would gradually be demonetized, and the bad money would drive out the good. But in the framework of the changes in reserve holdings proposed above and in intervention technique proposed below, it might become necessary to arrive at a more orderly policy of gold demonetization; such a policy would also avoid the new liquidity explosion that would occur if monetary gold were sold and subsequently revalued at a price considerably higher than the present official price of $38 an ounce. Gold stocks could be turned over to the IMF in return for SDRs on a voluntary basis but otherwise in the same way as proposed for the reserves in the form of national currency. Through gold sales on the free market when necessary, the Fund could use this gold to avoid or reduce a wide spread between the monetary and the commodity price of gold, thus bringing about a gradual and orderly demonetization of present monetary gold stocks. The profits accruing from such sales of gold somewhat above the official price could be handed over to the participating countries, in proportion to the gold

deposited with the Fund. A less radical alternative would be for the Fund to keep the gold acquired by it under the scheme. Monetary gold would thus tend to become concentrated in the Fund, and this might increase confidence in the SDRs issued by it. A country leaving the Fund would have the right to buy back the gold it had deposited.

A further question to be considered is what is to be done with the considerable dollar, pound, and perhaps franc balances that the IMF would receive under the consolidation arrangement. Since what is involved here is the counterpart of credit that the reserve centers have received, the obvious course is to ask for repayment of these credits. Since it would not make sense to bring about sizable balance-of-payments fluctuations, such amortization payments would have to be spread out over an extended period of time, say thirty or perhaps even fifty years. The redemption payments would be made in SDRs earned and accumulated by the former reserve centers in the course of their normal transactions.

Debt amortization through payment of SDRs to the IMF leads to a destruction of liquidity. From the monetary point of view alone, therefore, amortization is by no means necessary; on the contrary, it raises the question of how this destruction of liquidity is to be compensated for. Compensation could be achieved by an extra allocation of SDRs to all participants in the amount of the amortization payments. Or this extra allocation of SDRs could be used for an internationally agreed objective such as the financing of development aid, thus giving the developing countries a direct and concrete interest in the reform of the system. The advantage of this form of utilization of SDRs for the financing of development aid in comparison with other ways of doing so is that fixed amounts are involved, namely, the amortization payments to be made. Consequently, the determination of "international monetary policy," that is, the decision-making process as to the volume of the creation of new SDRs, is not encumbered by a conflict of interest between countries. Such a conflict would clearly arise if newly created SDRs, that is, SDRs created other than by way of compensation for SDRs received in payment by the IMF as amortization, were to be used for the financing of development aid.

By a consolidation scheme along the lines sketched above, symmetrical financing with reserve assets of surpluses as well as deficits by the present reserve centers would come within reach. In this important sense, the convertibility of the dollar would be restored and that of the pound sterling and the franc maintained. Two preconditions would, however, have to be met. In the first place, the reserves of the United States would have to be restored to an appropriate level. A long-term reserve loan might prove necessary for this purpose. In the second place, new deficits

on the part of the reserve centers would have to be avoided by arrangements ensuring that exchange rates were being kept at realistic levels. This brings us to the requirements that the exchange-rate system should meet.

The Exchange-Rate System

The exchange-rate system that was in effect until August 15, 1971, is known as the system of fixed par values. The par values, however, were fixed only until further notice, for they could be changed, with IMF approval, in the event of fundamental disequilibrium. In view of this, it is enlightening to follow Machlup (1971) in making a distinction among (1) unalterable parities, (2) jumping parities, (3) gliding parities, and (4) no parities. When this distinction is made, it becomes clear that the differences between practicable alternatives are not as great as one might think at first.

Unalterable parities are impossible in practice, and hence this system, which would in many respects be the most desirable one, is out of reach. To maintain parities unchanged it is necessary not only for domestic price movements due to inflationary pressures in the various countries to remain permanently in line, but also for internal cost and price movements to adapt themselves fully to the changes made necessary by continuing structural transformations affecting the basic competitive position. One example of such a structural transformation is the introduction of entirely new products, which is occurring at a rapid but unequal rate in different countries. It has been estimated that in ten years' time some 50 per cent of world trade will be in goods that are not yet being produced. Other examples of changes in the fundamental economic relationships are the discovery or the exhaustion of natural resources, and spontaneous shifts in international demand. When we observe the difficulties the authorities are encountering everywhere in realizing even a modicum of price stability, we must conclude that it is impossible to achieve an adequate adjustment of domestic cost levels to the constant shifts these changes bring about in comparative advantage among countries. The internal adjustment mechanism is inadequate—it has to be supplemented by the external adjustment mechanism in the form of parity changes.

Thus unalterable parities are impossible. The other extreme alternative, no parities, has little to recommend it. *Freely* fluctuating rates do not fit into the way modern economies are managed. National authorities consider it necessary to control many prices to attain their objectives, and the exchange rate, affecting as it does domestic prices, incomes, and employment, is too important a price to be left unregulated. It is, for ex-