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THE WORLD MONETARY SYSTEM:
A MINIMAL REFORM PROGRAM

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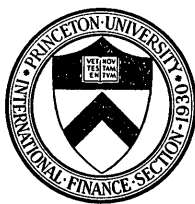
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The World Monetary System: A Minimal Reform Program

This essay attempts to answer two questions: In what aspects of its performance is it reasonable to ask that the world monetary system be improved? What rules or instruments can reasonably be negotiated or enacted to bring about these improvements? Some writers prefer to start with a list of requirements that a well-designed system should meet, or with a set of axioms whose logical implications can be allowed to determine the ultimate characteristics of the system. These are perfectly good—not to say elegant—ways of proceeding, but they do have one common property that I should like to avoid if possible: the systems that are ultimately excogitated are very tautly designed. There is no redundancy, very little in the way of optional extras, no room for building on extra bits or lopping off unattractive features.

One virtue of the piecemeal approach used in this paper is to separate aspects that are essential from those that are merely desirable. Another virtue is that, by proceeding from the system as it is now, it minimizes the issues on which agreement has to be reached: “Where we cannot agree, leave things as they are,” is the implicit rule. One weakness of this pragmatic attitude is that we cannot be sure the machine we have tinkered with will ultimately run; at a later stage, therefore, we shall give it a test outing.

The essay first tries to describe the system as it is at the moment. It then proceeds to examine the main complaints that have been levied against it, trying to distinguish fair complaints from mere idealistic grumbles and to collate the improvements it is reasonable and necessary to seek. A third section makes suggestions for building on the extra bits of machinery that seem to be required. Section 4 deals with the gold price and possible “two world” solutions, and suggests that the present system, reformed minimally along the lines of this essay, can survive well enough to make extreme alternatives unattractive.

The argument leading to the recommendations of the third section can be summarized as follows. The system has been changed significantly by the American devaluation of 1972 and by other exchange-rate changes since 1967. Differences of view about the system today are for the most part the reflection of real or imagined clashes of national interest. Intellectual dissension about exchange-rate flexibility, convertibility, and other issues still exists, but the arguments apply very differently to different

countries. There is some limited need for formal reform of the system, but all countries, and in particular large countries, have to face the fact that their freedom of action in all matters affecting foreign payments is limited. If the large countries can agree among themselves on capital-account policies and on technical assessments of trends in balances of payments, the required constitutional reform of the system is quite small. If they cannot agree, then no reform is possible or useful.

I. What Is the System Now?

The par-value system. The International Monetary Fund (IMF) has 120 members. Some ten or twenty are dominantly primary producers with virtually no industrial production; they sell their exports on a world market for commodities in which they take the prices offered and buy their imports on a world market for manufactures in which, once again, they are price takers. For these countries, the exchange rate need not be of major importance, and, for the international community, the way such countries choose their exchange-rate policy is not a central issue.

Another seventy or eighty countries of the developing world live, by choice or accident, in conditions of open or repressed inflation and engage in more or less frequent devaluations. Certainly, whenever one of these countries wants to devalue, the world community does not object—the IMF does not insist that exchange rates be maintained to reinforce domestic anti-inflationary policies. Indeed, the IMF has often connived in establishing a parallel free-exchange market where downward movements lead (or pull) down the official rate. True, the developing country has to consider its export competitors, who may resist an apparent attempt to obtain a beggar-my-neighbor advantage, as well as the effect of devaluation on domestic policies. But this sort of dispute is endemic and does not arise because of a malign quirk in the system-as-it-is. “Flexibility” for developing countries cannot be said to be inhibited by the present rules of the game.

We now come to the industrialized countries, accounting for three-quarters of world trade and for most of the complaints about world payments. Consider first the smaller but still significant countries such as Australia, Austria, and Norway. This group has not made much use of exchange-rate changes in the past, perhaps mistakenly. But in the world of 1972, any of these countries, if suffering at all palpably from a payments disequilibrium, could move its rate up or down uninhibited by the international system; par-value changes would go through the IMF virtually on the nod. The reluctance of the governments of these countries to

change their rates when necessary arises to only a small extent from fears of destabilizing speculation or doubts about making a new rate stick; with the possible exception of Australia, this group of countries is preoccupied with domestic issues in making decisions, as is only right. It is possible, as I argue later, that the option of "small and possibly frequent" parity change, if more explicitly open to IMF member countries, would be attractive to this group of countries.

The smaller members of the Group of Ten (Italy, Benelux, etc.) may feel that rather more international restraint is imposed on them. Countries of this type can be forced to revalue upward, as the events of 1971 showed, when their main trading partners move, but only after much pressure and argument. Downward moves might be tolerated in times that are generally calm, without emulation by non-Europeans, provided a clear need were shown. It is the pressures of the European Economic Community (EEC) that inhibit devaluation. It may be true that the smaller Group of Ten countries have been damaged in the past by a world prejudice in favor of "rigid" exchange rates. Although Italy's famous refusal to devalue in 1964 was a deliberate act of domestic policy, this example and others may provide evidence that, while the international system itself has not deterred exchange-rate variation, the system and its spirit have in the past reinforced prevailing domestic notions that rates should be fixed. If the same economic conjuncture developed in Italy again, however, the authorities would probably choose a modest devaluation, and, if this proved difficult internationally, the Treaty of Rome should take the blame, not Bretton Woods.

We are left with five countries, out of the original 120, whose exchange-rate policies are interlocked and determined by the system. Of those five, the United Kingdom, France, Germany, and Japan would all experience significant international difficulties if they tried to devalue, however obvious the disequilibria to which they were responding. The British float of June 1972 is the exception that proves the rule. A general impression was formed—in markets and official circles around the world—that a sterling parity of \$2.60 was markedly too high. In face of this prejudice, right or wrong, the British authorities had to follow the market "promptly" (as spokesmen had put it prophetically earlier in the year). But the depreciation was tolerated by Britain's trading partners only because the case was conceded to be so strong. In more doubtful cases (e.g., the need some observers claim to discern for sterling to sink below \$2.40), unless the authorities make up their minds before the market, hints of devaluation would dramatically affect reserves and induce defensive actions (and, worse, defensive speeches) like those

of 1963 to 1969. Ministers frequently promise to be good and often promise to be "timely" in their exchange-rate actions, but it is hard for them to promise to be clever and even harder to promise that the market will never be stupid.

Moreover, all these currencies occupy key positions in world trade and payments, partly because of formal roles as reserve assets, partly because much of world trade is financed or invoiced in these key currencies. Many smaller but not insignificant countries are likely to move with one or another of the big four. This likelihood, in turn, increases the reluctance of any big country to tolerate the attempt of another to steal a competitive advantage by a devaluation that is excessively prompt.

Equally, it has in the past been brutally clear, and remains likely, that currency appreciation will be resisted by more than one country in this group. The branch of government responsible for domestic monetary policy might welcome appreciation as an alternative to speculative inflows; the central bank might not wish to take in further reserves (although, if rational, it would be even more unwilling to see a depreciation of the home-currency value of those reserves it already holds); but the branch of government responsible for home employment and the export industries' prosperity will resist appreciation, particularly by large steps, because it is hard to replace lost export- or import-competing sales through fiscal expansion.

Thus, stickiness of exchange rates for these four countries is a characteristic of the present system that is hard to overcome, not so much because of the system but because of unavoidable structural interdependence.

There remains the United States, which has now demonstrated, at the expense of a rather risky six-month crisis, that she can devalue the dollar. Presumably, appreciation must also be seen as a possibility, though it is hard to imagine international pressure activating a President to urge upon Congress a reduction in the gold price.

The international exchange-rate system of 1972 therefore provides for easy devaluation by all save a small handful of countries, some of which (members of the EEC) are more directly inhibited by their own special interrelations than by the international system as such. Not many countries are likely to be flexible upward, except those for which the accumulation of reserves is clearly a wasteful way of investing national savings.

Long-term capital flows. Exchange rates have to be adjusted not to the needs of the current account alone, but also to capital-account flows. Disputes about the capital account are not evidence of a systematic flaw

in the world monetary apparatus, but instead reveal a major disagreement about the role and desirability of U.S. capital exports, which no constitutional reform will resolve.

The outward flow of long-term capital from most advanced countries is determined by the interplay of three alternative constraints. First, the government may anticipate a balance-of-payments problem because of its unwillingness or incapacity to devalue: increases in foreign investment have then to be compensated by some multiple contraction of home-resource use; and, in consequence, foreign investment would be constrained by the limited willingness of governments to deflate the home economy for balance-of-payments reasons. I suggest that this constraint is in practice not now much regarded, because most governments assume that, in the long run, they will be able to attain an equilibrium exchange rate.

Second, governments may recognize that the financing of any given capital-account deficit requires an equal current-account surplus. At any given pressure of demand, exports are alternative to domestic absorption, and governments may be unwilling to manage their use of exchange rates and domestic resources so as to generate sufficient saving for diversion into the foreign balance. This second constraint, although similar to the first, must be sharply distinguished from it.

Third, entrepreneurs may not be sufficiently willing to make foreign direct investments; or asset holders may not be sufficiently willing to acquire portfolio paper; or financial institutions may be unwilling to float foreign issues.

If the third constraint is below the second, it alone is effective; if the second constraint is below the third, government controls will be required, and the second constraint rules. German capital outflow is ruled by the third constraint, British by the second.

Note that controls usually impose a limit on the use of home currency to buy foreign currency for external investment. Most controls therefore work by inducing resident companies to seek foreign finance for their foreign operations. The accumulation of foreign assets is influenced very little; what the controls achieve is the accumulation of liabilities to foreigners and the freeing of domestic saving to finance capital accumulation at home, rather than export surpluses.

For the United States, the game has been, and remains, strikingly different. None of these constraints has really been important. Although some have talked as if the first balance-of-payments constraint has operated, the structure of controls erected in the 1960's and still in place today was not chosen as an alternative to domestic deflation: no one

seriously believed that U.S. imports should be curbed by creating slack in the domestic economy, in order to balance the international books. Equally, few American economists seem to be concerned with the second constraint; perhaps because Keynesian fine tuning of the economy is advocated by a different group from those who actively favor exchange-rate flexibility, the fact has not been explicitly noted that one of the main purposes of the recent devaluation was to divert resources from the domestic to the foreign sector—a task other countries have found painful. The trade-off between home and foreign use of resources has not been discussed. Hence the only difference of opinion in the United States is between those who would like to see the controls abolished and to leave it to foreigners to take the dollars or take the (dollar-depreciation) consequences, and those who think it desirable, in both the national and the international interest, deliberately to choose a lower exchange rate so as to achieve “basic balance” with whatever level of outward investment U.S. business elects.

Thus the system has been characterized by a basic asymmetry with respect to capital outflows and their financing. The United States has erected an apparatus of controls, corresponding to no felt domestic need, purely to satisfy what Americans perceive to be the requirements of the international system. The rest of the world regards controls on capital outflows as a regular instrument of economic policy, associated with, but not necessarily determined by, the exchange-rate regime. Naturally, American commentators are more hostile to this system than are some European or Japanese economists, but in their understandable annoyance some Americans may miss the point. Foreign insistence that the United States regulate its outflow does not rest on some arcane unwillingness of foreign central banks to take dollars or on an irrational refusal of foreign treasuries to allow the United States to attain the current surplus needed to finance a free capital outflow. It rests, at least in part, on a vague unwillingness of foreign governments to sell domestic fixed assets, even in return for otherwise unrequited American exports, let alone in return for liquid dollar assets. On certain plausible assumptions, this unwillingness may be economically irrational, but it is nevertheless a political fact of life.

This fact of life should be distinguished from the superficially equivalent reluctance of high-wage countries to tolerate low-wage imports. In the trading case, it is the domestic reallocation of resources that is resisted; in the capital-account case, it is the international redistribution of the ownership of factors of production that is deplored. Nevertheless, few countries have been able to resist a direct capital inflow, whatever

their public posture, and although Japan did set some limits on portfolio inflow, most other countries made no such attempt. There was a reluctance to apply in specific cases the general theoretical objections to capital inflow, because domestic interests would usually find the individual transactions attractive; only where identifiable entrenched interests would clearly suffer was the general principle of restrictionism triumphant. Hence, a sort of experimental neurosis was induced in some countries receiving inflows: they asked, loudly and shrilly, how it was that the main capital-exporting country was free of the several constraints that limited outflows from most other countries.

Summarizing, the situation can be characterized as follows: Most countries (other than the United States) are confined by one constraint or another on capital outflows; some advanced countries receiving inflows (particularly from the United States) would wish, on politico-economic grounds, to resist them, but such resistance is often difficult for domestic reasons. The recipient countries therefore turn to the United States and complain that the international regime must be at fault; otherwise, the U.S. outflow would be limited at source. In fact, the absence of effective U.S. constraints on outflow arises from the wealth and weight of the U.S. capital market (which makes the third constraint inoperative) and from the size of the U.S. economy (which makes the management of resource use in obedience to the second constraint unattractive to the U.S. authorities).

The long-term capital account is therefore a double source of contention and confusion, and the situation is confounded still further by the ambivalent attitude of the IMF toward capital controls. The Articles of Agreement allow (almost encourage) capital control; Fund practice has been to object (usually mildly) to most practical manifestations of such controls, on the grounds that they are discriminatory *de facto* or disruptive of free current transactions. A highly stylized and possibly unfair stereotype of earlier Fund attitudes would have been: If free capital outflows lead to deficits, higher domestic interest rates will both help to keep long-term flows at home and encourage equilibrating short-term flows. Today, the Fund staff is probably nearer the American view that downward exchange-rate flexibility for the dollar will control capital outflows (by raising their price to the investor) and will finance them (by generating appropriate current surpluses). Recipient countries, however, will be as unwilling to accept this argument from the Fund as they have been to accept it from the United States. There is, here, a basic clash of view and understanding that will not be resolved by any magic reworking of the monetary system.

Official liquidity and short-term flows. At the end of 1970, possibly the last quasi-equilibrium observation, world reserves stood at \$100 billion, of which some \$50 billion were holdings of foreign currency, four-fifths of it in dollars. Annual changes in the dollar slice of official reserves depended in a sense on the U.S. basic balance of payments, but could be explained statistically by changes in the relative size of the official and unofficial components of the *stock* of dollars held by foreigners, and by net short-term *flows* between the United States and the rest of the world. These changes accounted for the dominant part of the annual increment in total world reserves through the 1960's.

This situation gave rise to a string of complaints that we shall examine below. Here we need note only (a) that the annual creation of Special Drawing Rights, inaugurated in 1968, already represents between 1 and 3 per cent of the existing volume of reserves; a modest increase in their rate of creation could probably satisfy most economists' concern for meeting the need for official liquidity as such; and (b) that even Draconian controls, on the British or French scale, cannot stop significant flows of short-term funds between countries, which necessarily lead to swings in the *ownership* of world reserves (though not to changes in the world *volume* of reserves, save in the case of the present dollar system). Hence, any world system has to live with short-term flows—either by allowing exchange rates to move or by financing the flows by collective action.

One way of describing the present system is to say that the stock of world reserves is entirely demand-determined. The supply of dollars is infinitely elastic, and foreign central banks, through their own monetary policy (interest rates) and exchange-rate policy (balance of payments), influence the stock of dollars held officially abroad. This seems as good a definition as any of the "dollar standard."

Convertibility. We must first ask what this highly charged word really means. In 1947, fulfilling a commitment undertaken as part of the U.S. loan agreement of 1946, the United Kingdom announced the convertibility of sterling for current transactions. Nonresidents who had acquired sterling as a result of sales of goods or services to the United Kingdom were thereby entitled to receive dollars in exchange, at the official rate, from the Bank of England. This experiment was suspended after six weeks, and it was not until eleven years later that the United Kingdom formally assumed convertibility obligations under Article VIII of the IMF Articles of Agreement—though, for many years before, *de facto* convertibility was assured by back-door intervention that kept "transferable sterling" (sterling that could be used by any nonresident to settle current sterling debts) near the official par value.

The U.S. obligation in respect of convertibility was always defined under IMF Article IV, Section 4(b), as an obligation to supply gold in return for dollars—an obligation similar to, but not identical with, the obligation on most other countries to supply dollars in exchange for their own currency. It was this convertibility on demand that was formally suspended in August 1971, though it had virtually ceased in March 1968 or even earlier. However, it was not the formal closing of the gold window that provoked the generalized float in the autumn of 1971, but the implied determination of the U.S. authorities to seek an effective depreciation of the dollar against other currencies. It had taken only one and a half days in March 1968 to force the Group of Ten to accept the suspension of the gold pool and an implicit shift toward effective inconvertibility; the struggle of 1971 was a hundred times longer because the stakes this time were real—exchange rates that would influence output and employment.

The suspension of U.S. obligations, however, had no direct effect on world trade and payments, whereas when the United Kingdom suspended convertibility again after the abortive experiment of 1947, sterling ceased to be usable (at any fixed or reliable value remotely approaching parity) for buying nonsterling primary commodities or prized industrial products. The inconvertibility of the dollar in 1972 had no such meaning. Dollars are *de facto* and *de jure* convertible into all other currencies, and can be used to settle all debts, at exchange rates maintained by other countries within legally controlled limits of parity. Thus “inconvertibility” is an odd word to describe the present situation, and “convertibility” an odd target to place before the U.S. authorities in current negotiations.

What the United States does not do under present circumstances is to finance its over-all balance-of-payments deficit (however defined) with assets; *de facto* it had ceased to use that form of finance to any material degree long before 1971. In the decade ending in 1970, the U.S. basic deficit had amounted to \$17 billion, and its asset loss to \$6 billion. The United States had financed its deficits by issuing claims upon itself—by running up nonresident claims on the United States. Thus, inconvertibility really means “claim financing” and convertibility really means “asset financing” of U.S. deficits.

Even when clarified in this way, the issue is not emptied of muddiness or controversy. But it is important to note that the essence of the issue is as we have stated it, *not* the superficial and contingent reflection of that essence which is the “intervention” or “numeraire” role of the dollar. The United Kingdom and most other large countries deal in one currency only—the U.S. dollar—to maintain their par-value obligations.