Tomorrow's Convertibility: Aims and Means of International Monetary Policy *

Introduction

The convertibility decisions of last December were both overdue and ill-prepared. They were long overdue in the light of the enormous and steady improvement of Europe's balance of payments position over the last nine years. They were ill-prepared because they merely trusted to luck and neglected to build up any defenses against the most obvious dangers of an unorganized, nationalistic gold-exchange standard, so amply and catastrophically demonstrated by the rapid collapse of a similar " reconstruction " after the first world war.

Such was the gloomy theme of a previous article in this review (1). The present article will strike a more hopeful note by trying to explore some of the means by which the new convertibility could be given more solid foundations and contribute, at the same time, to a more rapid and balanced growth of the world economy.

Before venturing new and constructive suggestions in this respect, however, it is necessary to clear the air of two plausible, but illusory, solutions to the more immediate difficulties that may spring up within the next two or three years from the impending shortage of international reserves and liquidity.

The first — an upward revaluation of gold — is widely advocated and anticipated in " practical " financial circles, but finds very little audience in academic circles, with the outstanding exception of Sir Roy Harrod.

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* Following a time-hallowed custom, the author regretfully warns the reader that the views expressed in this study do not necessarily reflect in any way the opinions held by the official organizations with which he has been, or is now, associated.

(1) See my article in the March issue, " The Return to Convertibility: 1926-1931 and 1958 - ? ".

The second — freely fluctuating exchange rates — is, on the contrary, anathema to business opinion, but increasingly finds favor today with economic theorists — such as Professors Meade, Friedman, Haberler, etc. — as the miracle drug that will make international balance compatible with obdurately irresponsible national monetary and fiscal policies.

The reader who has remained blissfully impervious to either or both of these fallacious solutions to the world monetary problem will be well advised to skip my discussion of them in the first section of this paper, and to turn directly to the second section on p. 139.

I. Two False Solutions to the World Liquidity Problem

A Revaluation of Gold

Although basically absurd, a drastic revaluation of current gold prices is by no means an unlikely solution to the world illiquidity problem. It will become well-nigh unavoidable — and far preferable indeed to the alternative solutions of world deflation or world restrictions — if international negotiation fails to develop in time other and more constructive solutions to the problem.

The stability of gold prices from the Napoleonic era to the first world war remains so far a unique exception in world history, explainable by the extraordinary development of national bank credit and paper money, on the one hand, and of gold production, on the other, in the nineteenth century (2). The persistent upward trend of gold prices throughout history is dramatically illustrated in the accompanying Chart, reproduced from the 1951 Annual Report of the Bank for International Settlements (p. 157). The implication that " the current gold price, according to the trend of long history, would seem to be just right " (3) is, however, more specious than obvious, since very different conclusions would be drawn from similar charts of gold prices in terms of other major

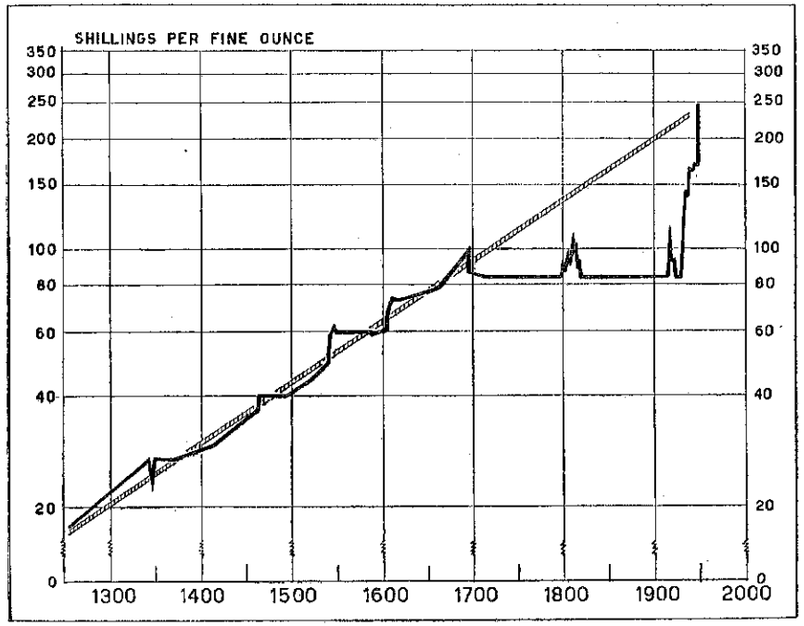
(2) Gold production is estimated to have risen from a yearly average of about 0.37 million ounces in the previous three centuries to 3.72 million ounces — or ten time as much — in the nineteenth century, and 19.23 million ounces in the thirteen years preceding the first world war.

(3) *Monthly Letter*, First National City Bank, February 1959, p. 23.

currencies. If " right " in terms of shillings, the gold price would, by the same reasoning, be far too high in terms of French francs, for instance, and far too low in terms of dollars. The only conclusions which might be retained from such historical records are:

1. that gold production has rarely kept pace, over the long run, with the monetary demand for gold arising from different,

GOLD PRICE IN LONDON OVER SEVEN CENTURIES



but nearly uniformly upward, trends in prices and economic activity in different countries;

2. that this gap has been met, throughout history, by differential rates of currency debasement or devaluation in terms of gold, as well as by the expansion of other types of monetary instruments, particularly paper money and bank deposits; and

3. that this historical trend is likely to assert itself persistently in the long run, and to entail a continuous or periodic depreciation of national currencies in terms of gold, whenever alternative means

are not found to provide an adequate supply of monetary liquidity — international as well as national — for an expanding world economy.

Such a result, however, is not unavoidable. It can be obviated if — and this is admittedly a big IF — international negotiations and agreements can be substituted for *laissez faire* and inertia. The arguments against gold revaluation should be powerful enough to elicit a determined effort in this direction.

First of all, the increase in gold prices needed to stimulate adequate annual supplies of monetary gold would have to be very steep indeed. Such supplies would probably have to be doubled or tripled — in dollar terms — to meet the problem as appraised in my preceding article in this *Review* (4).

Secondly, this gold revaluation operation would have to be repeated at periodic intervals, in order to keep pace with the cumulative growth of the world economies.

Thirdly, each of these revaluations would result in a temporary excess of world liquidity, due to their impact upon the valuation of existing gold reserves at the time. A fifty per cent revaluation, for instance, would produce today an overnight increase of gold and foreign exchange reserves of nearly $20 billion for countries outside the Soviet bloc.

Fourthly, the benefits of gold revaluation would be distributed very haphazardly and, indeed, in just about the least desirable fashion imaginable. High reserve countries would benefit most, and low reserve countries would benefit least, from the revaluation of existing stocks. The USSR would undoubtedly be the major beneficiary in this respect after the United States. It would, moreover, be the largest beneficiary by far, together with South Africa, of the consequent rise in the dollar value of current gold production (5).

These considerations explain and justify the adamant objections of the United States to a deliberate increase of gold prices in terms of the U.S. dollar. Such a decision could only be forced upon the

(4) See particularly Table VI, p. 33.

(5) USSR gold holdings are estimated at possibly $7 billion or more, and USSR gold production in 1957 at about $600 million, nearly equal to that of South Africa, and four times as large as that of the next largest gold producing country, Canada. See Oscar L. Altmann, "A Note on Gold Production and Additions to International Gold Reserves", IMF *Staff Papers*, April 1958, p. 282.

American authorities as the outcome of a prolonged or acute economic or financial crisis, which could hardly fail to involve serious setbacks in the recent progress toward monetary convertibility and trade liberalization.

Last, but not least, the world liquidity requirements can certainly be put to better use than the financing of more and more earth-digging in South Africa, the USSR, Canada, the United States and Australia.

Flexible Exchange Rates

The most radical versions of the flexible exchange rates proposal would nearly do away with any need for international monetary reserves altogether. The foreign exchange market should be left fully to the free interplay of supply and demand, without any intervention whatsoever by Central Banks or official Stabilization Funds.

The major argument advanced in favour of this proposal is that exchange rate fluctuations would then automatically offset the impact of disparate national policies upon the international pattern of prices and costs, and preserve in this manner long-run balance in each country's international transactions without recourse to trade or exchange restrictions, and without any interference with each country's freedom to pursue whatever internal monetary and credit policies it chooses. Temporary disequilibria in the balance of payments would be recognized as such by private speculators whose purchases or sales would cushion such imbalance with only moderate movements in actual exchange rates. Persistent disequilibria would, on the other hand, elicit similarly disequilibrating speculation which would amplify the overall market imbalance, accelerate the movement of exchange rates, alert public opinion, and force the monetary authorities to readjust their policies earlier than they would have done otherwise.

A full discussion of these views would require far more space than can be given to them here. My basic objection to them, however, is that actual disequilibria in the exchange markets are not exclusively related to disturbances in the international cost and price pattern. Under convertibility conditions, an excessive rate of credit expansion, particularly in a small country, may spill out very quickly into balance of payments deficits, long in advance of any

substantial price increases, these being held down anyway by the competition of imports from abroad (6). The depreciation of the national currency under the free interplay of market supply and demand would, however, stimulate increases in import prices which would, in turn, affect internal price, cost and wage levels in general. Speculation would accelerate and amplify these disequilibrating movements without, of and by itself, correcting the internal financial policies which lie at the root of the balance of payments deficits. If, however, such policies were continued indefinitely, the accelerated currency depreciation and price rises could hardly fail either to end in a currency collapse or, more probably, to induce the authorities to resort to stringent trade and exchange restrictions, bringing to an end the flexible exchange rates experiment. If, on the other hand, the authorities decide, instead, to arrest their inflationary rates of monetary and credit expansion, price and wage rigidities will make it difficult to reverse the intervening cost increases. The new " equilibrium " exchange rates, even in the absence of renewed inflationary forces, will be lower than would have been the case if exchange flexibility and speculation had not previously driven exchange rates, import prices, and overall wage and cost levels further than they would have gone under a system of pegged exchange rates. Resistance to downward cost and wage adjustments would tend to impart a " devaluation bias " to any system of exchange rate flexibility, and this bias could not fail to make private exchange speculation far less " stabilizing " than envisaged by the proponents of exchange rate flexibility.

The theoretical expectations and probabilities briefly summarized above would seem to fit reasonably well the historical record of exchange rate flexibility, as applied by countries which did not maintain an appropriate balance in their internal monetary and credit policies. A large number of European countries did, indeed, adopt exactly the proposed system of exchange rate flexibility after the first world war, their Central Banks abstaining fully or largely from any intervention on the exchange market. In most of these cases, the ultimate result was either a complete currency collapse — as in Germany and Central Europe — or a driving down of

(6) See my paper on " Adjusting Features in the Mechanism of the Balance of Payments and Exchange rates ", in the *Hearings before the Subcommittee on Foreign Economic Policy*, 79th Congress, Washington, D.C., 1955, pp. 134-142.

exchange rates to levels which considerably undervalued the currency in question — as in France and Belgium. The reversal of speculative transactions, following internal financial stabilization, did of course result in large repatriation of capital and a steep recovery of the national currency on the exchange markets. This appreciation was usually stopped in fact by the authorities at a point which left the currency somewhat undervalued. When allowed, or encouraged, by the authorities to proceed further, it led to an overvalued rate which, when stabilized by official interventions, entailed heavy deflationary pressures on the economy — as in Italy and the United Kingdom. There is certainly no empirical support for the view that the wide exchange fluctuations and speculation of the 1920's helped restore anywhere equilibrium exchange rates, either while the experiment was pursued, or when it was finally terminated by *de facto* or *de jure* currency stabilization.

Some of the proponents of flexible exchange rates would concede that much and agree that such policies can only be successful if used in combination with " correct " monetary, fiscal and credit policies. In this case, however, flexible exchange rates would be likely to remain fairly stable anyway, as private speculation could then more reasonably be expected to cushion temporary disequilibria. There is no reason to think, however, that this job would be done better by private speculators than by the country's monetary authorities. The latter are presumably better informed than the first. They are also entrusted with national responsibility for the country's currency, and could hardly afford to wash their hands of any responsibility for exchange rate stabilization or management, in the hope that the job will be performed better by private speculators whose motivation may not coincide in all cases with the national interest.

The most efficient way of eliciting " stabilizing " interventions from the private capital market would indeed be for the exchange authorities to intervene systematically in the market in such a way as to keep exchange rate fluctuations within a well-known range. As long as confidence is maintained in their ability to do so, private speculators may be counted upon to buy or sell the national currency against foreign exchange whenever the limits of this range are approached. Wide rate fluctuations are not necessary to stimulate such behaviour on their part, and might on the contrary induce " destabilizing " interventions as more and more people might then

be tempted to " ride the market " whenever a rising or declining trend gathers momentum.

There is, moreover, an important difference between the internal monetary impact of private stabilizing interventions, on the one hand, and of similar interventions by the Central Bank, on the other. In the latter case, the sale or purchase of foreign currencies by the Bank directly affects internal liquidity in a way which contributes to the balance of payments readjustments. The substitution of private capital movements in this role tends, on the contrary, to cushion the domestic as well as the foreign impact of the imbalance in the country's other external transactions, and to suppress at its roots the operation of the classical theory of monetary adjustment. Such " sterilization " or " neutralization " of the domestic impact of external imbalance may be desirable in some cases, but not in all. The Central Bank is always free, of course, whenever it deems it desirable, to offset by deliberate policy action the automatic bias toward " neutralization " implicit in private stabilizing speculation. Such " neutralization of neutralization ", however, complicates rather than simplifies the job of monetary management. On balance, stabilizing interventions by the Central Bank itself, with their implicit bias toward internal monetary adjustments, would often present advantages over private stabilizing interventions with their implicit bias toward neutralization.

There remains, however, a hard core of validity in the theory of flexible exchange rates. This is that exchange rate readjustment to " realistic " levels is preferable to vain and costly attempts to preserve " unrealistic " exchange levels through persistent reserve losses, foreign borrowings, or trade and exchange restrictions. All three of these techniques, and particularly the first two, may be desirable to defend an equilibrated rate of exchange against the impact of purely temporary imbalance. The third of them, however — *i.e.* trade and exchange restrictions —, has often been used for prolonged periods in the face of fundamental price and cost maladjustments. The damage to the national economy is then obvious. Temporary restrictions, widely recognized as such, may induce a postponement of expenditures until the restrictions are lifted. Long lasting restrictions are most unlikely to have such an effect. They will induce instead a drying up of capital imports, an expansion of legal — or illegal — capital exports, and a reshuffling of expenditures from prohibited imports

to domestically produced goods. If substantial unemployment prevails at the time, this latter effect may be desirable, but still less so than an exchange rate readjustment which would stimulate exports as well as reduce imports, restore balance in the capital market and avoid unnecessary distortions in resource allocation. If, however, as is frequently the case, the deficit coincides with a situation of full, or overfull, employment, the diversion of demand from foreign to domestic sources of supply can only lead to a corresponding reduction in the country's exporting capacity, and/or an accentuation of internal inflationary pressures.

A readjustment of exchange rates would be preferable in both cases to a permanent system of trade or exchange restrictions (7). After a period of disturbance, or pending the full success of an internal stabilization program, it may also be advisable for the monetary authorities to postpone temporarily any commitment to a new and stable exchange rate whose " correct " level may be difficult to gauge under the circumstances.

These solid arguments against abusive, and largely illusory, resort to restrictions and against the obstinate maintenance of exchange rates at unrealistic levels should not be extrapolated into a blanket approval of flexible rates as a universal panacea for balance of payments management. Neither do they offer a satisfactory solution to the international liquidity problem raised in the last issue of this *Review*. Adequate reserve levels are no substitute for desirable exchange readjustments, but inadequate reserve levels will still entail undesirable recourse to exchange devaluation or restrictions, and introduce in international trade and payments unnecessary disturbances highly dangerous for the smooth functioning and effective preservation of currency convertibility.

II. The Internationalization of International Currency Reserves

Gold has long ceased to provide adequate amounts of international liquidity for an expanding world economy. New gold production and USSR sales supplied less than one half of the

(7) In the second case, however, a downward readjustment of overall expenditures to a level corresponding to the maximum practicable use of the country's productive resources will certainly be necessary, and may even in some cases obviate the need for any exchange rate readjustment. See the article quoted above, p. 5, footnote 6.

increase in world reserves over the years 1950-1957, and are unlikely to cover much more than one third to one half of prospective reserve requirements in the foreseeable future (8).

Barring a drastic revaluation of gold prices, the maintenance of adequate reserve levels will thus continue to depend on the growth of foreign exchange reserves as a supplement to gold itself. This, however, cannot fail to increase further and further the vulnerability of the world monetary system to shifts of confidence — justified or unjustified — in the national currencies actually used as reserve media. A repetition of 1931 would, at some point, become well-nigh unavoidable.

The logical solution of this dilemma would lie in the "internationalization" of the foreign exchange component of monetary reserves. The use of *national* currencies as *international* reserves constitutes indeed a "built-in de-stabilizer" in the world monetary system. The free choice of reserve holders will normally tend to concentrate on the "safest" currencies available for this purpose, *i.e.* on the currencies of the major creditor countries. In accumulating such currencies as reserves, however, reserve holders are really extending "unrequited" loans to these countries, and increasing further the natural hardness of their currencies. Such lending, moreover, does not relieve the international liquidity shortage if the key currency countries increase their own gold holdings *pari passu* with the rise in their international short-term liabilities. They can relieve the situation, and avoid a "scarce key currency" condition from developing, only if they succeed in re-lending abroad — or giving away in the form of grants — amounts sufficient to finance not only their current account surpluses, but also the inflow of unrequited borrowings corresponding to the accumulation of their currency as reserves by other countries. If this is done, and as long as it continues to be done, the international liquidity problem will be solved, and the authorities of the key currency countries may possibly welcome the political influence which may be derived from this increase in their international lending capacity (9).

(8) See the March issue of this Review, pp. 31-34.

(9) Economic advantages may also flow from the fact that the loans extended by the key currency countries will usually bear higher rates of interest than those paid on their short-term liabilities and may help promote exports to the borrowing countries. The first of these two considerations, however, obviously does not apply to the re-export of capital in the form of grants.

The process, however, is bound to come to an end at some point. The key currency countries cannot afford to let their net reserve position deteriorate indefinitely. If they did, their currency would stop, in any case, to be considered as the safest, and the time would come when other countries would cease accumulating it, and might even begin converting some of their outstanding holdings into gold or other currencies. When this stage is reached, the key currency country will be faced with difficult readjustments in the previously built-in structure of its international transactions. Isolationist, economy-minded, and protectionist groups will find in such a situation powerful arguments in favor of a curtailment of foreign aid programs and of a reversal in the liberal trading policies previously pursued. These types of remedies, however, may be not only internationally damaging, but also less effective in practice than would appear at first, since the curtailment of both foreign aid and imports is most likely to be offset, to a substantial extent, by a decline in exports.

Whatever the policies adopted to readjust the country's balance of payments and arrest the gold outflow, their success will inevitably entail, at the very least, a cessation of the key currency country's current contributions to the solution of the international liquidity problem. Their failure, on the other hand, may have far worse consequences still by stimulating large-scale liquidation of outstanding foreign held balances, and triggering off an international financial panic involving other currencies as well. This is precisely what happened in 1931, and led temporarily to the near-elimination of foreign exchange balances from monetary reserves by all countries outside the sterling area. Nobody can deny the role of these events in the intensification of the world crisis in the early 1930's.

In brief, the constitution of international reserves in the form of a national currency tends to stimulate unrequited lending to the major creditor country and add to the difficulties which it may already face in financing its surpluses abroad. If it fails in this task, the gold shortage will remain unsolved but appear instead in the guise of a shortage of the main creditor country's currency. If, on the other hand, it redistributes abroad sufficient grants and credits to finance not only its current account surpluses, but to offset in addition the unrequited inflow of short-term funds from abroad, its net reserve position will gradually deteriorate to the point

where its currency no longer appears as absolutely safe to reserve holders. The flow of reserve funds will then tend to slow down, or even to reverse itself, in such a way as to accentuate again overall balance of payments disequilibria, rather than cushion them. The readjustments imposed at this stage upon the creditor country will, if successfully carried out, arrest at the very least its previous contribution to the maintenance of an adequate level of international liquidity. There is a serious danger, however, that a less skillful handling of the situation may result in a sharp reversal of liberal trading policies throughout the world, or even trigger off large scale movements of short-term funds from one currency into another and from all currencies into gold.

The most logical escape from these difficulties is obvious enough, and would have been adopted long ago if it were not for the enormous difficulties involved in overcoming the forces of inertia and reaching agreements among several scores of countries on the multiple facets of a rational system of international money and credit creation. This is, of course, the only explanation for the survival of gold itself as the ultimate means of international monetary settlements. Nobody could ever have conceived of a more absurd waste of human resources than to dig gold in distant corners of the earth for the sole purpose of transporting it and re-burying it immediately afterwards in other deep holes, especially excavated to receive it and heavily guarded to protect it. The history of human institutions, however, has a logic of its own. Gold as a commodity enjoyed undoubted advantages over other commodities that could alternatively be used as money. The substitution of debt or paper money for commodity money within each country's national borders was a slow, gradual, and still recent phenomenon in world affairs. Its extension to the international sphere is even more recent and has also developed haphazardly under the pressure of circumstances rather than as a rational act of creation on the part of any national or international authority. This explains the present, and totally irrational, use of *national* currencies as *international* reserves. Yet, the proliferation of regional, international, and supranational agencies since the war is slowly laying the groundwork for further, and long overdue, adaptations in the international monetary system, and particularly for the internationalization of the fiduciary portion — foreign exchange — of countries' monetary reserves.

This was indeed the keystone of the famous Keynes Plan for an International Clearing Union (10). The one vital provision of the plan, on which its whole structure rested, lay in the proposed commitment of all member states to accept, in lieu of gold payment and without any limit whatsoever, bancor transfers to their credit in the books of the Union in full settlement of any balances due to them from any other members (Article 6, paragraph 6). Of and by itself, such a provision would have endowed the Clearing Union with an equally *unlimited* lending capacity, since " no member State would be entitled to demand gold from the Clearing Union against its balance of bancor ". This was made explicit in Article 29 and also in Article 5: " If no credits can be removed outside the clearing system, but only transferred within it, the Union can never be in any difficulty as regards the honoring of checks drawn upon it. It can make what advances it wishes to any of its members with the assurance that the proceeds can only be transferred to the clearing account of another member. Its sole task is to see to it that its members keep the rules and that the advances made to each of them are prudent and advisable for the Union as a whole ".

Keynes correctly characterized this vital feature of the Plan as the logical extension into the international field of the essential principle underlying the development of national banking systems. Keynes' remarks on this point are well worth re-reading, and deserve the extensive quotations which follow.

The acceptance of unlimited bancor accounts by creditor countries would be no real burden to them. " For the accumulation of a credit balance with the Clearing Union would resemble the importation of gold in signifying that the country holding it is abstaining voluntarily from the immediate use of purchasing power. But it would not involve, as would the importation of gold, the withdrawal of this purchasing power from circulation or the exercise of a deflationary and contractionist pressure on the whole world, including in the end the creditor country itself. Under the proposed plan, therefore, no country suffers injury (but on the con-

(10) All the following references will be to the official text of these " Proposals by British Experts for an International Clearing Union ", dated April 8, 1943, as reproduced in the *Proceedings and Documents of the United Nations Monetary and Financial Conference*, U.S. Government Printing Office, Washington, 1948, Vol. II, pp. 1548-1573.

trary) by the fact that the command over resources, which it does not itself choose to employ for the time being, is not withdrawn from use. The accumulation of bancor credit does not curtail in the least its capacity or inducement either to produce or to consume " (Article 11).

" In short, the analogy with a national banking system is complete. No depositor in a local bank suffers because the balances, which he leaves idle, are employed to finance the business of someone else. Just as the development of national banking systems served to offset a deflationary pressure which would have prevented otherwise the development of modern industry, so by extending the same principle into the international field we may hope to offset the contractionist pressure which might otherwise overwhelm in social disorder and disappointment the good hopes of our modern world. The substitution of a credit mechanism in place of hoarding would have repeated in the international field the same miracle, already performed in the domestic field, of turning a stone into bread " (Article 12).

" No particular member States have to engage their own resources as such to the support of other particular States or of any of the international projects or policies adopted. They have only to agree in general that, if they find themselves with surplus resources which for the time being they do not themselves wish to employ, these resources may go into the general pool and be put to work on approved purposes. This costs the surplus country nothing because it is not asked to part permanently, or even for any specified period, with such resources, which it remains free to expend and employ for its own purposes whenever it chooses; in which case the burden of finance is passed on to the next recipient, again for only so long as the recipient has no use for the money. As pointed out above, this merely amounts to extending to the international sphere the methods of any domestic banking system, which are in the same sense " impersonal " inasmuch as there is no call on the particular depositor either to support as such the purposes for which his banker makes advances or to forego permanently the use of his deposit. There is no countervailing objection except that which applies equally to the technique of domestic banking, namely that it is capable of the abuse of creating excessive purchasing power and hence an inflation of prices. In our efforts

to avoid the opposite evil, we must not lose sight of this risk... But it is no more reason for refusing the advantages of international banking than the similar risk in the domestic field is a reason to return to the practices of the seventeenth century goldsmiths (which are what we are still following in the international field) and to forego the vast expansion of production which banking principles have made possible. Where financial contributions are required for some purpose of general advantage it is a great facility not to have to ask for specific contributions from any named country, but to depend rather on the anonymous and impersonal aid of the system as a whole. We have here a genuine organ of truly international government " (Article 40).

The last words of this quotation reflect the only valid objection to the whole argumentation of Keynes. The objection is political, not economic, in nature. From a narrowly economic point of view, Keynes is perfectly correct. Bancor accounts would, under his plan, have been just as good as gold. Although the bancor accumulation of creditor countries would serve as a basis for the extension of credit to others, the liquidity of the creditors' accounts would remain unimpaired, since they could always be used as freely as gold itself to make payments anywhere in the world. The political objection, however, was a double one.

First and foremost is the risk, admitted by Keynes, of an unwise use of the Clearing Union's lending facilities to finance inflationary, rather than merely expansionist, policies throughout the world. This would reduce the real value of the creditors' accounts — including their gold as well as their bancor reserves — and expose them to stronger inflationary pressures than would have been the case in the absence of such inflationary lending by the Union. This would appear, on the surface, as a reasonable *economic* objection to the Plan. If, however, the creditor countries themselves were in agreement with the Union's lending policies, they could hardly complain about the consequences of decisions in which they fully concurred. The core of the problem lies therefore in the voting procedures of the Union, and in the loss of sovereignty which they may involve. Various safeguards might conceivably be set up in this respect and allay in part the creditors' legitimate fears in this respect. Those provided in the Keynes Plan, however, were totally inadequate,

and little ingenuity was shown by any of the participants in devising better ones (11).

A second objection, from the point of view of prospective creditor countries, lay in the "impersonality" or "anonymity" of the Union's lending. Keynes saw in this a major virtue of the Plan, as it was indeed from an international viewpoint and, even more, from the point of view of prospective borrowers such as the United Kingdom in the early postwar years. It would also entail, however, a diminution of the political influence and bargaining power that the lending nations could otherwise derive from direct loan negotiations with the borrowing countries. Properly speaking, this should not be regarded as a legitimate objection to the Plan, but rather as an obstacle in the way of its successful negotiation in a nationalistic world.

The predominantly political nature of these difficulties must be fully recognized in trying to devise realistic formulas for feasible progress toward international agreement in this field. One of the major implications of such an approach will lie in distinguishing what may be accomplished through world-wide agreements and what may prove achievable only on the regional scale within smaller and more homogeneous groups of highly interdependent countries, keenly conscious of their interdependence, and better prepared by a common geographical and historical background to understand one another's problems and policies.

III. The International Monetary Fund Today

The International Monetary Fund, as presently constituted, can only bring a limited, although still extremely valuable, contribution to the world liquidity problem.

Past and Current Loans

The Fund's lending operations, over its twelve years of existence, are summarized in Table I. Gross loans totalled $759 million

(11) A simple, but extreme, solution, could have been to impose the unanimity rule on all important lending decisions of the Union. That this might not have been as paralyzing a provision as might appear at first can be demonstrated by the experience of OEEC, in which this rule has always been observed. Less extreme solutions will be discussed later in this paper.

TABLE I

A. - IMF LENDING, 1947-1958
(in millions of U.S. dollars)

	Apparent Borrowings (1)	Repurchases of Borrowers' Currencies by Other Members (2)	True Borrowings (3=1—2)	Repayments by Borrowers (4)	Net Borrowings (5=3—4)	Cumulative Net Borrowings at end of period (6)
I. *1947–1949*	*777*	*17*	*759*	*2*	*757*	*757*
1947	468	6	462	—	462	462
1948	208	11	197	—	197	658
1949	101	—	101	2	99	757
II. *1950–1955*	*439*	*186*	*254*	*777*	*– 523*	*234*
1950	—	—	—	24	– 24	733
1951	35	28	7	46	– 39	694
1952	85	—	85	102	– 16	678
1953	230	158	72	163	– 91	587
1954	62	—	62	210	– 148	439
1955	28	—	28	232	– 205	234
III. *1956–1957*	*1,670*	—	*1,670*	*177*	*1,493*	*1,727*
1956	693	—	693	113	579	814
1957	977	—	977	64	913	1,727
IV. *1958*	*338*	*21*	*317*	*348*	*– 31*	*1,696*
V. *Total* . .	*3,224*	*224*	*3,000*	*1,304*	*1,696*	

B. - IMF UNUSED LENDING COMMITMENTS, AT THE END OF 1958

I. *Undrawn Amounts Under Stand-by Arrangements*	*911*
A. United Kingdom	738
B. Other Countries	173
II. *Net Credits and Gold-Tranche Commitments*, of which:	*2,580*
A. Major Creditor Countries	2,452
1. United States	1,958
2. Germany	147
3. Canada	90
4. Netherlands	69
5. Japan	62
6. Belgium	56
7. Italy	45
8. Sweden	25
B. Other Countries (1)	128

(1) After elimination of $5 million overlap with stand-by arrangements.

in the first three years (1947-1949) but were largely repaid in the following six years, bringing down the amount of outstanding loans to only $234 million at the end of 1955. The Suez crisis was followed by an unprecedented level of activity. The Fund's net lending rose by nearly $1,500 million in two years and has remained since then at a cumulative level of approximately $1,700 million.

There are also outstanding, in addition, about $900 million of unused drawing rights under so-called stand-by agreements, and all countries have been assured "the overwhelming benefit of the doubt" for borrowings within their so-called "gold tranche", *i.e.* up to the amounts actually contributed by them to the Fund in the form of paid-in gold subscriptions and of the Fund's use of their national currency subscriptions. Taken together, these unused facilities amount to about $2,450 million for the major creditor countries listed in Table I, $740 million for the United Kingdom, and $300 million for all other countries taken together (12).

Lending Capacity

The future lending capacity of the Fund — and thus its ability to alleviate the prospective world liquidity shortage — is far more difficult to appraise.

The sum of all quotas measures both the total lending commitments and borrowing "facilities" of the Fund's members. Since, however, the same country cannot be at the same time a net lender and a net borrower, the maximum net lending commitments usable at any time cannot possibly exceed half of this sum, unless widespread waivers allowed debtor countries to borrow in excess of their total quotas. The extreme limit of the Fund's present lending capacity could be estimated, on this basis, at about $4.3 billion (13).

(12) The outstanding Fund loans ($1,700 million at the end of 1958) are included as part of the borrowing countries' gross reserves in the Tables presented in my article in the March issue of this Review (pp. 3-57). Net claims on the Fund and drawing rights available under stand-by agreements are not reported, however, as part of the countries' monetary reserves.

(13) Members' quotas totalled about $9.2 billion at the end of 1958, but included nearly $950 millions of unpaid subscriptions. Unless otherwise noted, all the estimates discussed in this paper assume full payment of these subscriptions, with the exception of that of Nationalist China whose large unpaid quota ($550 million) obviously bears no relationship to its prospective lending to, or borrowing from, the Fund.

This would be raised to about $6.75 billion after the quota increases recently approved by the Fund's Board of Governors have gone into effect.

This, however, is a rather theoretical estimate. It should first be modified to take account of past Fund operations which have deeply modified the outstanding lending commitments and borrowing rights of a number of countries. These operations are summarized in Table II. The Fund's resources as of the end of 1958 — excluding all unpaid subscriptions — can be read from line 10 of this Table. They included $1.5 billion of gold and $6.7 billion in about three scores of members' currencies. More than half of this latter sum, however, was made up of currencies for which the Fund has never received any request, and which are most unlikely ever to be sold by it in any significant amounts. Most of them are indeed currencies of underdeveloped countries — such as India, Brazil, Pakistan, etc. — who should be expected to be frequent borrowers from the Fund, rather than net lenders to it. The Fund's holdings of the six currencies ever lent by it in its twelve years of operation totalled little more than $3 billion, of which more than $1.6 billion, however, was in the currency of the Fund's largest net borrower, and less than $1.2 billion in the only three currencies ever *really* borrowed from the Fund on a net basis (14).

A more realistic, even though still highly conjectural, appraisal of the Fund's true lending capacity may be gauged from Table III. Ten alternative calculations are presented, based upon different assumptions as to the currencies requested from the Fund by future borrowers. For simplicity's sake, only eight currencies have been retained for this purpose, and some of them have been grouped together rather arbitrarily. It will generally be agreed that very few of the other Fund currencies could be added to this list. This would not, in any case, increase substantially the resulting estimates of the Fund's lending capacity, as the amounts involved would be small at best, and could not possibly be used simultaneously with the eight currencies shown without widespread and large scale waivers of quota limits on the remaining borrowing countries.

(14) The occasional Fund's sales of sterling, Dutch guilders and Belgian francs have always been offset, or indeed far more than offset, by previous borrowings of these three countries from the Fund. See lines 1 and 3 of Table II.

IMF CURRENCY AND GOLD TRANSACTIONS, 1947-1958

(in millions of U.S. dollars)

TABLE II

Fund's Receipts (+) or Disbursements (—)	U.S. Dollars	German Marks	Canadian Dollars	Belgian Francs	Dutch Guilders	Pounds Sterling	Other Currencies	All Currencies	Gold	Total
1. Member's Borrowings (+)	—	—	—	+ 83	+ 144	+ 862	+ 2,135	+ 3,224 (d)	x	+ 3,224
2. Other Members' Borrowings (—)	— 2,916	— 69	— 15	— 11	— 5	— 208	—	— 3,224 (d)	x	— 3,224
3. Total Net Borrowings (1+2)	— 2,916	— 69	— 15	+ 72	+ 139	+ 654	+ 2,135	x	x	x
4. Repayments	+ 1,000	—	—	— 72	— 39	— 108	— 985	— 305	+ 305	x
5. Cumulative Net Borrowings (3+4)	— 1,916	— 69	— 15	—	—	+ 545	+ 1,150	— 305 (e)	+ 305 (e)	x
6. Other (a)	— 46	—	—	—	—	+ 13	+ 4	— 29	+ 52	+ 22
7. Total Fund's Receipts or Disbursements (5+6)	— 1,962	— 69	— 15	—	—	+ 558	+ 1,154	— 334	+ 356	+ 22
8. Purchases of Currency against Gold (b)	+ 692	—	—	—	—	—	—	+ 692	— 692	x
9. Total Change in Fund's Holdings (7+8)	— 1,270	— 69	— 15	—	—	+ 558	+ 1,154	+ 358	— 335	+ 22
10. Residual Holdings (c) (11+9)	792	183	210	169	206	1,618	3,562	6,740 (d)	1,532 (f)	8,272
11. Quota Subscription (c)	2,062	252	225	169	206	1,060	2,408	6,382	1,867	8,249

(a) Fund's administrative expenditures (—), and miscellaneous receipts (+) arising mostly from payment of charges in the paying member's currency.

(b) Including $92 million directly received from members in U.S. dollars in lieu of gold subscriptions.

(c) Excluding all unpaid subscriptions.

(d) Including $2 million due to be paid in instalments by withdrawing member (Czechoslovakia) by July 1961.

(e) Represents the difference, received in gold by the Fund, between the currencies "sold to the Fund" by net borrowers ($1,696 million) and the currencies of creditors countries "sold by the Fund" in the course of these operations ($2,000 million).

(f) Including $200 million in U.S. Treasury Bills and funds awaiting investment obtained from proceeds of gold sales and reconvertible into the same quantity of gold upon termination of investment.

If the U.S. dollar remains in strong demand by the Fund's borrowers (lines VI 1, a, b, and c), the Fund's maximum lending capacity, after the increase in quotas, would be of the order of $4.5 to $7.4 billion, depending on how many — and how much — of the other currencies are also in demand. The latter sum, however, could not actually be lent by the Fund without substantial waivers (more than $1.5 billion) of quota limits on all other members' borrowings.

The substitution of sterling for the dollar as the main currency in strong demand (lines VI 2, a, b and c) would not modify greatly the above estimates, except that the substitution of the United States for the United Kingdom as an extreme borrower would enable the

same lending capacity — and indeed much more — to be used even in the absence of any waivers of the borrowing quotas.

In the absence of any demand for either U.S. dollars or pounds sterling (line VI 3,), the Fund's maximum lending capacity would remain well below $6 billion.

Finally, if both U.S. dollars and pounds sterling were in strong demand (lines VI 4, a, b and c), the Fund's lending capacity could be of the order of $6.7 billion to $9.5 billion, any amounts in excess of $7.5 billion, however, requiring once more extensive waivers in favor of borrowers.

All these are, of course, extreme hypotheses, which suggest the maximum limits rather than the plausible scope of the Fund's future lending. Loans much in excess of, let us say, $5 billion could hardly fail to be accompanied with a threatening scarcity of some creditors' currencies and would probably require a depletion of the Fund's gold assets endangering its ability to honor, in the desired currencies, its moral commitment to give every member the "overwhelming benefit of the doubt" to drawings within its gold tranche.

Yet, even a $5 billion lending capacity should be more than adequate to meet for several years to come the world liquidity shortage, roughly estimated in my previous article at some $6 billion to $17 billion over the next decade (15). This is all the more true as the reserve position of all major reserve holders, outside the United States, improved considerably during 1958. These countries — including the United Kingdom and France — are less likely to require any large scale Fund assistance in the near future. The Fund will thus be able to devote most of its resources to loans to the non-industrialized countries whose need for such assistance is greatest, particularly in view of the alarming deterioration of their balance of payments and reserve position during the last few years.

(15) These figures, however, are not really comparable. First of all, borrowings within the gold tranche are included in this $5 billion estimate and would constitute merely a recovery by the borrowers of amounts they have themselves lent to the Fund. Many of the lending countries, moreover, do not regard as monetary reserves their net claims on the Fund arising from their gold contribution and the use of their national currency subscription. The main contribution of IMF lending to world liquidity, therefore, lies much less in the creation of additional liquidity than in the "activation" of the pre-existing stock of world reserves. The "inactive" reserves of creditor countries are placed at the disposal of, and used by, borrowing countries whose reserve levels are particularly deficient. To this extent, the Fund's loans increase the velocity, rather than the quantity, of world reserves.

IMF LENDING CAPACITY — TABLE III

(in millions of U.S. dollars)

	Fund's Lending Capacity			Quota Borrowing Facilities of Other Members					
	Current Fund Holdings	Proposed Quota Increases	Total	Total	U.S.	U.K.	Other Drawn Currencies (IV)	Other Major Currencies (V)	Other Countries
I. Gold	1,532	1,210	2,742						
II. U.S. Dollars	792	1,031	1,823						
III. Pounds Sterling	1,618	487	2,106						
IV. Other Currencies Drawn in Past Operations	768	718	1,486						
1. German Marks	183	343	526						
2. Canadian Dollars	210	187	397						
3. Dutch Guilders	206	103	309						
4. Belgian Francs	169	84	253						
V. Other Major Currencies	975	384	1,359						
1. French Francs	787	197	984						
2. Japanese Yens	187	187	375						
VI. *Alternative Patterns of Lending Capacity:*									
1. *Gold and U.S. Dollars*									
a. only (I+II)	2,324	2,241	4,565	9,774	—	1,794	2,688	1,215	4,077
b. plus other drawn currencies (I+II+IV)	3,092	2,959	6,051	7,086	—	1,794	—	1,215	4,077
c. plus other major currencies (I+II+IV+V)	4,067	3,343	7,410	5,871	—	1,794	—	—	4,077
2. *Gold and Pounds Sterling*									
a. only (I+III)	3,150	1,697	4,847	14,407	6,427	—	2,688	1,215	4,077
b. plus other drawn currencies (I+III+IV)	3,918	2,415	6,333	11,719	6,427	—	—	1,215	4,077
c. plus other major currencies (I+III+IV+V)	4,893	2,799	7,692	10,504	6,427	—	—	—	4,077
3. *Gold and All Currencies Listed except U.S. Dollars and Pounds Sterling* (I+IV+V)	3,275	2,312	5,587	8,221	6,427	1,794	—	—	—
4. *Gold. U.S. Dollars and Pounds Sterling*									
a. only (I+II+III)	3,942	2,728	6,671	7,980	—	—	2,688	1,215	4,077
b. plus other drawn currencies (I+II+III+IV)	4,710	3,446	8,157	5,292	—	—	—	1,215	4,077
c. plus other major currencies (I+II+III+IV+V)	5,685	3,830	9,516	4,077	—	—	—	—	4,077

The breathing space thus made available by the increases in the Fund's quotas should be used by governments and their technical experts to explore the bolder and more imaginative reforms called for to adjust international monetary institutions to present-day needs and possibilities.

The most fundamental deficiency of the present system, and the main danger to its future stability, lies in the fact that it leaves the satisfactory development of world monetary liquidity primarily dependent upon an admittedly insufficient supply of new gold and an admittedly dangerous and haphazard expansion in the short-term indebtedness of the key currency countries. The most logical solution to the problem would lie in the substitution of IMF balances for such national currencies in all member countries' monetary reserves.

The acceptance of such a solution — under the necessary guarantees outlined below — would also eliminate most of the unnecessary complexities and limitations in the Fund's borrowing and lending techniques which now arise from their dependence upon fixed subscriptions of national currencies. The Fund's lending capacity could then be derived instead from the normal accumulation by members of a portion of their monetary reserves in the form of IMF balances, as fully and internationally usable as gold itself. As contrasted with present quota subscriptions, such balances would involve no sacrifice of liquidity for their holders, and their amounts could be made to adjust in a flexible manner to the future evolution of each member's reserve position.

The essential feature of such a solution is, of course, identical to the bancor proposal of Keynes, discussed on pp. 141-146 above. The concrete proposals that follow, however, differ in nearly all other respects from the Keynes plan and these differences are, in turn, dictated by two major preoccupations. The first is to meet squarely the political and economic arguments raised against it and which made it unnegotiable in practice, particularly from the point of view of the prospective creditor countries. The second is to remove a number of weaknesses of Keynes' proposals, ascribable in most cases to peculiarly British concerns and interests and to the highly abnormal and difficult conditions rightly foreseen by him for the early postwar years.

IV. A New Charter for the International Monetary Fund

The keystone of our proposals would be the substitution of IMF balances for balances in national currencies — *i.e.*, mostly dollars and sterling — in all member countries' monetary reserves. Such balances should be made equivalent in all respects to gold itself and as widely usable and acceptable in world payments.

The latter purpose would have been achieved in the Keynes plan through a binding obligation on each member country to accept unlimited amounts of bancor in settlement of any claims accumulated by it on any other member country. The bancor accounts thus credited to it could be spent freely for similar settlements to others, but would not give it any right whatsoever to withdraw gold from the Clearing Union. The acceptance of such a proposal would have endowed the Union with an equally unlimited lending capacity, restrained only in practice by the insufficient limitations placed by other provisions of the plan on each member's borrowing right or quota.

The major objection raised against the Keynes plan lay precisely in the enormous inflationary pressures to which the prospective surplus countries would expose themselves by accepting such wide commitments to bancor accumulation. A second objection lay in the fact that the creation of bancor money by the Union would not displace, but add to, the expansionary influence associated with any further growth of sterling and dollar balances. The maintenance of dollar and sterling balances as alternative, or supplementary, means of international settlement — alongside with gold and bancor — also meant that the Keynes plan would not have removed entirely the dangers and weaknesses arising from the operation of a gold exchange standard. Finally, further objections were validly raised against the automaticity of the large borrowing rights conferred upon future deficit countries.

These objections were met in fact by the abandonment of the key feature of the plan, and the replacement of bancor accounts by national quotas, dependent largely on national currency subscriptions to the IMF. The proposals that follow would, on the contrary, preserve the core of the Keynes plan mechanism, while meeting frontally the objections raised against it. They would retain IMF — or bancor — accounts as a fully multilateral means of

settlement, thus simplifying vastly the lending and borrowing operations of the institution, and guaranteeing in a much firmer fashion the continued interconvertibility of all member currencies against a relapse into discrimination and bilateralism in world trade and payments.

A. *Sources and Limits of the Fund's Overall Lending Capacity*

The IMF lending capacity would be based, as in the Keynes plan, on the accumulation of bancor accounts — in the form of deposits with the IMF — by member countries as part and parcel of their total monetary reserves, alongside with gold itself and fully equivalent to it in international settlements. This basic objective, however, requires neither that the Fund be endowed with an *unlimited* — and potentially inflationary — lending capacity, nor that each member country commit itself in advance to accumulate *unlimited* amounts of bancor in settlement of its surpluses.

The overall lending capacity of the Fund can properly be limited to the creation of bancor amounts sufficient to preserve an adequate level of international liquidity. Various criteria could be retained for this purpose. The simplest one might be to limit the Fund's net lending, over any twelve months period, to a total amount which would, together with current increases in the world stock of monetary gold, increase total world reserves by, let us say, 3 to 5 per cent a year (16). The exact figure could not, of course, be determined scientifically and would, in any case, depend in practice upon the compromise between divergent national viewpoints which would emerge from the negotiations of the new Fund Agreement. A reasonably conservative solution would be to retain the 3 per cent figure as definitely non-inflationary, and to require qualified votes (two thirds, three fourths, and ultimately four fifths of the total voting power, or even unanimity) to authorize lending in excess of 3, 4 or 5 per cent a year (17).

Assuming, for instance, that monetary gold stocks continue to increase by $700 million or $800 million a year, the Fund's annual

(16) See the March issue of this Review, pp. 31-33.

(17) Alternative criteria, more logical but also more difficult to define concretely, might be derived from the current trend of some international price index reflecting inflationary or deflationary pressures on the world economy.

lending quota based on a 3 per cent rate could be roughly estimated today at about $800 million to $900 million. A 4 per cent rate would raise this to about $1.4 billion, and 5 per cent to about $2 billion a year (18). These estimates would rise gradually, but slowly, with further increases in world reserves. They could decrease as well as increase, on the other hand, with future fluctuations in the current additions to the world monetary gold stock.

B. *Minimum Deposits Requirements*

What provisions would be necessary to induce member countries to finance such lending by the Fund through the accumulation of an equivalent amount of Fund balances as part of the annual increase in their total monetary reserves?

Most member countries have, for many years past, held a considerable portion of their monetary reserves in the form of foreign exchange — primarily U.S. dollars and pounds sterling — rather than gold. The percentage of foreign exchange reserves to total reserves averaged at the end of 1957 some 30 per cent for the world as a whole, and as much as 55 per cent for countries other than the United States and the United Kingdom (19). During the five years preceding the Suez crisis, official dollar balances alone increased at an average pace of nearly $1 billion a year.

The major stimuli to such accumulation are, of course, the lower costs incidental to the use of key currencies rather than gold in world settlements, and the earnings derived from the portion of a country's reserves held in the form of foreign exchange. The major deterrents to such accumulation, on the other hand, are the risks of exchange fluctuations, inconvertibility, blocking, or even default, inseparable from holdings in a foreign country's currency.

The shift from national currency balances to balances with the IMF could preserve fully the same incentives and decrease considerably at the same time the weight of the deterrents mentioned above. The Fund's earnings on its own loans and investments (20) should be distributed among members *pro rata* of the balances held by

(18) These calculations are based on the IMF estimates of world reserves — excluding international institutions — of about $54 billion at the end of 1958.

(19) See the March issue of this *Review*, pp. 24 and 40.

(20) See below, pp. 168-172.

them with the institution. These balances should — as all other Fund accounts — be expressed in a gold unit, and escape therefore the foreign exchange risk always attached to foreign exchange holdings in national currencies. They would similarly remain unaffected by any inconvertibility decision adopted by any individual member of the Fund. They could, at any time, be used by their holders as freely and widely as gold itself to make payments to any other member country, and even to non-members (21). These provisions should make it possible for all countries to count their balances with the Fund as a normal and valuable component of their monetary reserves, and as fully equivalent to gold for the calculation of reserve or gold cover requirements wherever legal provisions still exist in this respect.

These various advantages should ensure a considerable demand for Fund balances on the part of most member countries, and particularly on the part of those which are already holding a large portion of their monetary reserves in the form of foreign exchange rather than gold. Members' voluntary holdings of Fund balances might well exceed after a time the amounts needed to finance the Fund's lending operations, in which case a growing portion of the Fund's assets would take the form of gold.

This is not likely to become true, however, until members have grown fully familiar with the system and with the security, liquidity, and earning power of this new form of reserve asset. In the initial years at least, it will be necessary to require Fund members to hold with the institution balances amply sufficient to finance its lending and to guarantee — through a sufficient accumulation of gold reserves — the full convertibility of Fund balances into any currency, even the " hardest ", actually needed in settlements.

Both of these purposes could be achieved most simply by requiring all members to hold in the form of Fund deposits a certain proportion of their gross monetary reserves. All would agree to accept such deposits in settlement of their international claims without limit, but would have the right to convert at any time into

(21) The membership of the Fund now includes practically all countries outside the Soviet bloc, except Switzerland, Portugal and New Zealand. Some further efforts could be made to induce these three countries to join a reformed IMF, and the rest of our discussion will assume that these efforts have been successful. The special arrangements otherwise needed to enable members to draw on their Fund account for settlements to non-members would not create any serious financial burden for the Fund.

gold, if they so wish, deposits accrued to their Fund account in excess of this minimum requirement. This obligation would substitute for the present system of Fund quotas, and offer considerable advantages over it from the point of view of individual members as well as from the point of view of the Fund itself.

The first of these advantages would lie in the fact that such balances with the Fund would remain as fully liquid and usable in payments as gold itself, and should therefore — as already noted above — be considered as part of each country's monetary reserves. The maintenance of a portion of a country's reserves in this form would therefore be no burden on it and would not raise the internal financing problems which some countries now find in financing their quota subscription to the Fund (22).

The second advantage is that deposit obligations would adjust automatically to fluctuations in the overall reserve position of each country. The Fund's overall resources would thus increase as the overall level of world reserves increases. Most of all, however, the increase in Fund minimum deposit requirements would concentrate on the countries which currently develop net surpluses and whose currency is therefore most needed for international settlements. This flexibility should be contrasted with the rigidity, arbitrariness, and wastefulness of the present quota system which can be changed only infrequently and only through a laborious process of international renegotiations and of new national legislation on the part of all Fund members.

One question remains to be solved. What would be the minimum deposit requirements needed to ensure the Fund adequate lending power and ensure that this lending power remain fully multilateral, *i.e.* unhampered by the development of any particular currency " scarcity " in the Fund?

Tables IV and V present hypothetical calculations based on a 20 per cent level of reserve requirements. Gross reserves ($55 billion) exclude creditor countries' claims on EPU (about $1.4 billion), funded under the EPU liquidation agreement. They include, how-

(22) Since such subscriptions cannot now be used freely for payment by the subscriber, but merely give him a right to apply for Fund borrowings, many countries do not regard their creditor position with the Fund as part of their reserves. Subscriptions to, and claims on, the Fund must then be financed by the Government itself, either out of accumulated funds or through borrowings from its Central Bank or from the market.

COMPARISON OF MINIMUM IMF DEPOSITS WITH REVISED QUOTAS
ON THE BASIS OF MONETARY RESERVES AT THE END OF 1958

(in millions of U.S. dollars) TABLE IV

	Gross Reserves				Minimum Fund Deposits (5=20% of 4)	Revised Quotas	Excess Foreign Exchange (7=1+2—5)	Gold Payment (8=5—1—2)
	Net Claim on IMF (1)	Foreign Exchange (2)	Gold (3)	Total (4=1+2+3)		(6)		
I. United States	1.958	—	20,582	22,540	4,508	4,125	—	2,550
II. United Kingdom	—	255	2,850	3,105	621	1,950	—	366
III. Continental OEEC	367	6,360	9,590	16,317	3,263	3,136.5	3,913	449
A. *European Community*	*318*	*4,577*	*6,543*	*11,438*	*2,288*	*2,610.0*	*2,770*	*163*
Germany	147	2,587	2,639	5,373	1,075	787.5	1,659	—
France	—	376	589	965	193	787.5	183	—
Italy	45	1,219	995	2,259	452	270.0	812	—
Netherlands	69	338	1,050	1,457	291	412.5	116	—
Belgium-Luxembourg	57	57	1,270	1,384	277	352.5	—	163
B. *Other*	*49*	*1,783*	*3,047*	*4,879*	*976*	*526.5*	*1,143*	*286*
Switzerland	x	124	1,925	2,049	410	x	—	—
Portugal	x	211	493	704	141	x	70	—
Austria	12	464	194	670	134	75.0	342	—
Sweden	25	267	204	496	99	150.0	193	—
Norway	12	200	43	255	51	75.0	161	—
Denmark	—	199	31	230	46	102.0	153	—
Turkey	—	154	144	297	59	64.5	95	—
Greece	—	164	13	177	35	60.0	129	—
IV. Canada	90	870	1,078	2,038	408	550.00	552	—
V. Latin America	40	1,518	1,791	3,349	670	1,009.50	897	9
Venezuela	4	385	720	1,109	222	22.50	167	—
Brazil	—	140	325	465	93	225.00	47	—
Cuba	—	300	80	380	76	75.00	224	—
Mexico	22	194	144	360	72	135.00	144	—
Argentina	—	185	114	299	60	225.00	125	—
Uruguay	4	30	180	214	43	22.50	—	9
Colombia	—	89	72	161	32	75.00	57	—
Chile	—	19	40	59	12	75.00	7	—
Guatemala	1	21	27	49	10	7.50	12	—
Dominican Republic	2	33	12	47	9	15.00	26	—
Panama	—	48	—	48	10	0.75	38	—
Costa Rica	1	17	2	20	4	7.50	14	—
Ecuador	2	14	22	38	8	15.00	8	—
Peru	—	12	19	31	6	37.50	6	—
Honduras	2	8	—	10	2	11.25	8	—
El Salvador	2	6	31	39	8	11.25	—	—
Nicaragua	—	6	1	7	1	11.25	5	—

COMPARISON OF MINIMUM IMF DEPOSITS WITH REVISED QUOTAS
ON THE BASIS OF MONETARY RESERVES AT THE END OF 1958

(in millions of U.S. dollars) *Cont.* TABLE IV

	Gross Reserves				Minimum Fund Deposits (5=20% of 4)	Revised Quotas	Excess Foreign Exchange (7=1+2—5)	Gold Payment (8=5—1—2)
	Net Claim on IMF (1)	Foreign Exchange (2)	Gold (3)	Total (4=1+2+3)		(6)		
Paraguay	—	7	—	7	1	11.25	6	—
Bolivia	—	14	1	5	1	15.00	3	—
Haiti	—	—	1	2	—	11.25	—	—
VI. Outer Sterl. Area	22	3,394	755	4,173	835	1,368.0	2,583	—
Australia	8	958	162	1,128	226	300.0	740	—
India	—	475	247	722	144	600.0	331	—
Malaya	1	330	—	331	66	37.5	265	—
Ghana	—	301	—	301	60	22.5	241	—
Iraq	2	267	34	303	61	12.0	208	—
Ireland	4	244	18	266	53	45.0	195	—
South Africa	—	105	211	317	63	150.0	42	—
Pakistan	3	209	49	261	52	150.0	160	—
New Zealand	x	153	33	187	37	x	116	—
Ceylon	4	172	—	176	35	22.5	141	—
Burma	—	119	—	119	24	22.5	95	—
Jordan	—	46	—	46	9	4.5	37	—
Iceland	—	15	1	16	3	1.5	12	—
VII. Other	106	2,692	1,115	3,910	782	2,168.0	2,017	5
A. *Europe*	*19*	*257*	*109*	*386*	*77*	*297.0*	*199*	—
Finland	9	214	35	259	52	57.0	171	—
Spain	10	10	57	77	15	150.0	5	—
Yugoslavia	—	33	17	50	10	90.0	23	—
B. *Other*	*87*	*2,435*	*1,006*	*3,524*	*705*	*1,871.00*	*1,818*	*5*
Japan	62	807	54	923	185	500.00	684	—
Egypt	—	255	174	429	86	90.00	165	—
Thailand	3	215	112	330	66	18.75	152	—
Iran	—	112	141	253	51	52.50	61	—
Indonesia	—	180	37	217	43	165.00	137	—
Belgian Congo	x	104	83	186	37	x	67	—
Viet-Nam	3	159	—	162	32	18.75	130	—
Korea	3	145	2	149	30	18.75	118	—
Taiwan	—	102	9	111	22	825.00	80	—
Lebanon	1	16	91	108	22	6.75	—	5
Israel	2	91	2	94	19	11.25	74	—
Philippines	—	82	10	92	18	22.50	64	—
Ethiopia	1	53	4	58	12	9.00	42	—
Syria	2	12	24	37	7	9.75	7	—
Other	10	102	263	375	75	123.0	37	—
VIII. Total	2,583	15,089	37,761	55,432	11,086	14,307	9,962	3,379

Source and Notes: Reserve estimates are based on the latest reports for 1958 published in the April 1959 issue of *International Financial Statistics*. As explained in the text, claims on EPU are deducted from, and net claims on the IMF added to, these IFS estimates.

ever, members' net claims on the IMF, as these would be transformed into fully liquid reserve deposits with the Fund as a result of the reform proposed here. Countries would thus be required initially to hold in deposit with the Fund an amount of about $11 billion. This would increase year by year by 20 per cent of the new additions to members' gross reserves, and would be amply sufficient to cover all prospective Fund lending for many years to come. Some increase in this required reserve ratio might ultimately prove desirable, but it is highly probable that voluntary deposits would by then be so large as to make such a compulsory increase unnecessary in practice.

These minimum requirements may be compared with the revised Fund quotas soon to come into operation and which they are designed to replace. They are considerably smaller for most countries — and particularly for those with low reserves — and only slightly larger for a few countries with very high reserves: the United States ($380 million), Germany ($290 million), Italy ($180 million), Switzerland ($410 million), Venezuela ($200 million), Portugal ($140 million), Austria ($60 million), etc. They would be somewhat higher, however, for most countries than the 25 per cent gold portion of their subscription to the Fund, but it should be noted once more that the sums held in deposit with the Fund would retain their fully liquid character and be as, or more, usable in settlements as the portion of their reserves now held by most countries in the form of dollar or sterling balances.

In order to satisfy these minimum reserve requirements, all countries would have to transfer to the Fund equivalent amounts of assets. Three types of assets would be eligible for this purpose:

1. net creditor claims previously accumulated on the Fund; these would automatically be transformed into IMF deposits;

2. other liquid or semi-liquid foreign exchange holdings, *i.e.* primarily dollar and sterling balances;

3. gold.

If we assume that all countries would initially prefer to hold onto their gold assets, most of them would satisfy fully their reserve obligation by transferring to the Fund only part of their present foreign exchange holdings. Only a handful of countries — primarily the United States and the United Kingdom — would have

to transfer gold to the Fund in order to fulfil their deposit obligation (see column 8).

Table V shows the new balance sheet of the Fund after all such transfers have taken place. Nearly half of the Fund assets ($4.9 billion) would be in gold, and the rest in various claims on

HYPOTHETICAL IMF BALANCE SHEET AT END OF 1958 AFTER PROPOSED REFORM — TABLE V

(*in billions of U.S. dollars*)

Assets		Liabilities	
1. *Gold*	4.9	1. Members minimum deposits on current account	11.1
a. December 31, 1958 holdings	1.5	a. from members' net claims on December 31, 1958	2.6
b. New deposits	3.4	b. from additional gold and foreign exchange deposits	8.5
2. *Claims on Members*	6.2	2. Net earnings	0.02
a. December 31, 1958	1.1		
b. New deposits	5.1		
TOTAL	11.1	TOTAL	11.1

Note:

Based on Table IV above, on the assumption that countries maintain only the minimum required deposits with the Fund, and transfer gold to the Fund for this purpose only insofar as their foreign exchange reserves are insufficient to feed such required deposits.

member countries, but very largely in U.S. dollars (probably more than $3 billion) and in pounds sterling (probably close to $2 billion). There would be no reason to change the present repayment provisions covering existing Fund claims (about $1 billion) arising from past operations. Provision would have to be made, however, with regard to the new claims acquired by the Fund as a result of the proposed reform. These claims would represent mostly bank deposits and Treasury bills now held by member countries in New York or London as part of their monetary reserves. The Fund would have no immediate need to modify these investments, but should be empowered to do so, in a smooth and progressive manner, insofar as useful for the conduct of its own operations. This purpose would be served by giving the Fund an option to liquidate such investments at a maximum pace of, let us say, 5 per cent a year. The maximum yearly liability for repayment which this would

entail for the United States and the United Kingdom would be of the order of $150 million and $100 million respectively (23).

This pattern of Fund assets should rule out in practice any real danger of a "currency scarcity" in the Fund and guarantee therefore the full and continued convertibility of Fund deposits into any currencies needed by members. Currency sales by the Fund would be credited to the deposit accounts of the countries whose currency had been sold, and the large gold holdings of the Fund (nearly $5 billion) would enable it to meet any request by such members to convert into gold the excess of their deposits above their 20 per cent minimum requirement (24). Moreover, countries which are in debt to the Fund should not have an absolute right to such conversions. The Fund could, in such cases, insist upon extraordinary amortization of their debts to it as an alternative to gold repayments susceptible of jeopardizing its own liquidity. This would also constitute an additional safeguard against any scarcity of the two major currencies in world trade and settlements — the U.S. dollar and the pound sterling — in view of the large initial holdings (more than $5 billion) of these two currencies by the Fund.

C. *Fund Absorption of Residual Foreign Exchange Reserves*

The operations described above would absorb and consolidate a substantial portion (about $5 billion) of the foreign exchange reserves of member countries, but would still leave outstanding about $10 billion of such national currency reserves. In order to eliminate fully from the international monetary system the absurdities and dangers denounced above (25), these national currency reserves should also be converted into international Fund deposits. If this were done, the Fund's deposit liabilities estimated above at about $11 billion would rise to approximately $21 billion, and its foreign

(23) If a faster rate of repayment were deemed desirable, the 5 per cent option might be made to apply either to the debt itself — as suggested in the text — or to the excess of the country's gold reserves over a "normal" amount defined by the average ratio of world reserves to world imports. This second criterion would leave the United Kingdom's obligation unchanged, but would raise to about $750 million initially the annual repayment liability of the United States.

(24) The minimum deposit requirement itself would, of course, rise by 20 per cent of the amount credited to the member's account since such amounts would increase correspondingly the country's gross monetary reserves.

(25) See pp. 139-141.

exchange holdings to $16 billion. Its gold reserve would initially be left unaffected, at about $5 billion, or a little less than 25 per cent of total liabilities. This might be deemed uncomfortably low and entail a possible danger that the Fund might have insufficient gold to procure for its members a currency in strong demand in the event that the issuing country insisted on converting into gold any Fund deposits accruing to it in excess of its 20 per cent deposit requirement.

Such a danger, however, would be more remote than one might think. First of all, it could hardly materialize as far as the two major currencies in world trade and payments are concerned. The Fund would now hold indeed close to $9 billion in U.S. dollars and more than $5 billion in pounds sterling (26). A strong world demand for dollars or sterling should be met, in large part, by extraordinary amortization of this indebtedness rather than by equivalent gold settlement by the Fund of the balances accruing to these two countries beyond their 20 per cent deposit requirement.

The danger of an excessive depletion of the Fund's gold resources could thus come only from two other sources:

1. direct conversion into gold of the Fund balances acquired in exchange for the initial transfer to the Fund of the foreign currency balances now held by members; or alternatively;

2. a similar conversion into gold by the countries — other than the United States and the United Kingdom — whose subsequent overall surpluses are settled through transfers of Fund balances from the deficit countries' account to the surplus countries' account.

The first of these two dangers could be warded off as far as sterling balances — but not dollar balances — are concerned by providing that the conversion of national currency balances into Fund balances should not entitle their holders to claim gold from the Fund if the balances so transferred did not entitle them to claim gold from the country on which these balances were held. This would not impair in any way the convertibility of these Fund balances into all and any currencies actually needed by their holders

(26) Official dollar balances of foreign countries were reported at $8,662 million at the end of 1958, and total — official and private — U.S. Government bonds and notes at $983 million. Non-colonial sterling balances were estimated at about $6.9 billion. On the basis of the 1957 ratio of official to private sterling balances, this might be broken down roughly into $5.3 billion of official balances and $1.5 billion of private balances.

in international settlements, nor the gold exchange guarantee and other privileges attaching to Fund balances in general. What it would mean is that the right to claim gold from the Fund would attach only to the Fund balances exceeding the sum of the country's normal 20 per cent requirement *plus* the balances initially acquired in exchange for gold-inconvertible national currency balances. This second limitation, moreover, would be eliminated gradually as the debtors of such balances — primarily the United Kingdom — amortized their corresponding indebtedness to the Fund.

The only residual danger of an excessive depletion of the Fund's gold assets would then arise from the conversion into gold of deposits at the Fund transferred to overall surplus countries other than the United States and the United Kingdom. Let us note, however, that only 80 per cent, at most, of such transfers would expose the Fund to gold payments since 20 per cent of them would increase the minimum deposit requirements of the receiving countries. Secondly, the option of the Fund to claim annual amortization instalments from the debtors of the balances could be exercized, whenever necessary, and bring in up to $1 billion a year of additional gold resources to the Fund (27).

The danger of a gold or currency scarcity in the Fund would thus appear extremely remote, especially as most countries could be expected to hold Fund deposits well in excess of their minimum requirements. Convenience and earning incentives have so far prompted countries other than the United States and the United Kingdom to retain, on the average, more than half — rather than merely 20 per cent — of their gross reserves in foreign exchange rather than gold (28). They will have, in any case, to retain some working balances in a form other than gold in order to avoid repeated gold sales or purchases each time they wish to sell or buy foreign currencies in the market to stabilize their own exchange rate. These working balances will have to be held either as excess deposits with the Fund, or directly in the key currencies actively

(27) Under the formula described on p. 163 above, this option would normally apply to 5 per cent of the total currency balances (about $15 billion) transferred to the Fund, *i.e.* $750 million. It could, however, also be applied, alternatively, to 5 per cent of the excess of the debtor's gross reserves over and above the average ratio of world reserves to world imports. This would raise initially by about $300 million the annual repayment liability of the United States.

(28) See the March issue of this *Review*, Table X, p. 40.

traded on the exchange markets. Either of these two alternatives would reduce substantially the danger of an excessive gold drain from the Fund. Working balances equal to only 5 per cent of annual imports, for instance, would absorb as much as $5 billion.

All in all, therefore, the absorption and consolidation of all outstanding foreign exchange reserves — with the possible exception of moderate working balances — into Fund deposits would appear feasible, even on the basis of the 20 per cent minimum deposit requirement envisaged up to now. Yet, provision would have to be made to safeguard the Fund's liquidity both against unforeseen conversions of excess deposits into gold and, in the long run, against the increasing gap between the probable level of world gold stocks and the desirable expansion of overall monetary reserves. Three different techniques might be used — either alternatively, or in combination — to meet both problems. The simplest one would be for the Fund to issue medium-term gold certificates, payable either in gold or in excess Fund deposits, and carrying a higher rate of interest than liquid Fund deposits. Such certificates should be particularly attractive to high reserve holders. The second possibility would be to authorize the Fund to raise uniformly the 20 per cent deposit requirement to a higher ratio — 25 per cent or 30 per cent, for instance —, of each country's gross monetary reserves. The third would be to leave the basic 20 per cent requirement unchanged — or to increase it more moderately — but to impose higher deposit requirements upon that portion of each member's reserves which exceeds the average ratio of world monetary gold to world imports.

Any increase in the compulsory deposit obligation initially accepted by members should normally require a qualified majority (two-thirds, three-fourths, or even four-fifths) of the Fund's total voting power. If, however, such a majority could not be reached at a time when a real gold scarcity develops in the Fund, such a " gold scarcity " would have to be declared by the Fund and entail the automatic adoption of either the second or the third of the three solutions discussed above, to the extent necessary to preserve the Fund's ability to meet its gold conversion commitments. Any country should then have the right, however, to refuse to accept such an increase in its obligation. This would act as a declaration of " scarcity " of that particular country's currency in the sense of Article VII of the present Fund Agreement, and carry the con-

sequences envisaged in that Article (29). As different from the present — and politically inapplicable — procedure, however, such a declaration would be left to the discretion of the country concerned rather than of the Fund. In fact, our previous discussion makes it abundantly clear that such a contingency would be most unlikely to arise, at least for many years to come, and that confidence in Fund deposits should by that time be sufficiently strong to avert any such decision on the part of any country.

D. *Clearing and Lending Operations of the Fund*

As indicated above (30), the major safeguard against an inflationary level of Fund lending would lie in the overall limitations placed on the net increase of the Fund's loans during any twelve months period.

These loans should fall into two broad categories, similar in many respects to those of national central banks' credit operations:

1. advances or rediscounts, undertaken at the initiative of the borrowing country;

2. open market operations, or investments, undertaken at the initiative of the Fund itself.

Advances, Stand-bys and Overdrafts

The normal procedures for Fund advances need not differ substantially from those gradually developed by the Fund over its twelve years of existence. They should be subordinated to full agreement between the Fund and the member with relation not only to the maturity of the loan, but also to the broad economic and financial policies followed by the member to ensure long run equilibrium in its international transactions without excessive recourse to trade and exchange controls. The recent stand-by techniques of lending might, in addition, be supplemented by overdraft agreements, to be renewed at frequent intervals, and guaranteeing all members in good standing rapid and automatic Fund assistance in case of need, but for modest amounts and with short-term repayment provisions. These overdraft agreements would be primarily

(29) See also pp. 172-173, below.
(30) p. 156.

designed to give time for full consideration of a request for normal, medium-term, loans or stand-by agreements, and would be guaranteed by the country's minimum deposit obligation.

The only basic difference between the new lending procedures and the ones now in existence is that the proposed structure of Fund operations would eliminate one of the most puzzling requirements of the present Articles of Agreement. Article V, Section 3, Subsection (a) provides that "A member shall be entitled to buy *the currency of another member* from the Fund in exchange for *its own currency* subject to the following conditions: (i) The member desiring to purchase *the currency* represents that *it* is presently needed for making *in that currency* payments which are consistent with the provisions of the Agreement" (31).

This is very bizarre indeed and raises at least two broad questions. First of all, it is very difficult, under convertibility conditions, to identify *any particular currency* as needed by a member. The settlement of most international transactions takes place through private sales and purchases of foreign exchange in the market and need not involve the member itself, or its monetary authorities. The latter's *need* for foreign exchange arises only when they feel impelled to intervene on the exchange markets to repurchase excess supplies of their own currency and arrest its depreciation in terms of other currencies. They do not, even then, however, need any *particular* currency for this purpose, although they will presumably tend to operate chiefly in widely traded currencies and to sell preferably those which command the highest market price — in relation to their par value or official buying rate for foreign currencies — at that particular moment.

Secondly, it should be noted that the Fund Agreement allows members to purchase foreign currencies in exchange *for their own currency* — *i.e.* in exchange for their own I.O.U.'s — but not in exchange for other foreign currencies owned or acquired by them. This means in effect that the Fund could never really fulfill effectively one of the main purposes stated in Article I, Section (iv) of the Agreement, *i.e.* "to assist in the establishment of a multilateral system of payments in respect of current transactions between members...". This was a major gap in the Fund Agreement and made it necessary to set up in 1950 a separate institution, the

(31) The italics are mine.

European Payments Union to restore a multilateral system of settlements among the European countries and their associated monetary areas (32).

Both of these shortcomings would be remedied by the Fund reform proposed in this study. Bilateral settlements among central banks would be obviated through the use of the Fund as a Clearing House for such settlements. Foreign currency balances acquired by a central bank would be deposited to its Fund account and debited from the account of the debtor of such balances. Any other member's currency could, conversely, be purchased by a member through corresponding debits to its own account and credits to the account of the country whose currency is bought. Finally, any loan granted by a Fund to a member would be credited to its Fund deposit account, and the member could draw on this account in any currency whatsoever without having to make any "representation" that it needs it to make payments in that particular currency.

Fund Investments

The second broad category of Fund lending would take place through investments in the financial markets of member countries. These operations would be decided very largely at the initiative of the Fund itself, but always of course in agreement with the monetary authorities of the countries concerned. Such agreement would be necessary in any case to attach to these investments the same guarantees against exchange and inconvertibility risks as those which protect the Fund's own deposit liabilities.

The first investments of this character would be imposed upon the Fund by its absorption of the outstanding national currency reserves transferred to it by members in exchange for Fund deposits. They would be overwhelmingly dollar and sterling investments and would be subject to special provisions, already outlined above,

(32) The restoration of convertibility for non-residents by most major trading countries provides, as long as it lasts, an alternative machinery for the multilateralization of payments. It does not, however, dispense with the need to discourage through international cooperation and agreements later relapses into inconvertibility by a country in difficulty, nor with the need to help other countries withstand the impact of such a decision by one of their major trading partners. This is indeed one of the major objectives of the European Monetary Agreement which replaced, at the end of last year, the European Payments Union Agreement. A further discussion of the vital issues involved may be found in my book on *Europe and the Money Muddle*, Yale University Press, 1957, particularly pp. 113-116, 202 and 223-229.

to avoid unnecessary disturbances to the monetary and financial markets of the United States and the United Kingdom. The resources derived from their progressive liquidation, however, would normally be reemployed in other markets whose need for international capital is greater than in the United States and the United Kingdom. A portion of such investments might even be channelled into relatively long-term investments for economic development through purchases of IBRD bonds or other securities of a similar character.

A primary consideration in determining the pattern of Fund investments would be the need to preserve the full liquidity of its members' deposits. It should be noted, however, that the Fund would be in a particularly strong position in this respect as the total amount of its required deposits — initially some $11 billion — could hardly decline in practice, but would on the contrary grow year by year with the increase of world reserves. Any withdrawals of deposits by members whose overall reserves are declining would be more than matched by increases in the required deposits of members whose reserves are increasing (33). The liquidity problem of the Fund would be very largely confined to the preservation of the convertibility of its excess deposits into any currency needed in payment, and, eventually, into gold if their holders request it. This problem has already been amply discussed above and need not detain us further.

Further Suggestions

A number of other interesting suggestions relating to the Fund's lending procedures have recently been presented by Mr. Maxwell

(33) The theoretical possibility of a decline in the monetary reserves of all countries taken together should, however, be noted in passing. The only case on record is that of the first years of the great depression when world reserves declined by about $2 billion from 1928 to 1932 as a result of the wholesale liquidation of their foreign exchange assets by central banks. The above proposals are precisely designed to ward off the repetition of a similar collapse of the gold exchange standard. Overall world reserves could also decline through large-scale sales of official reserves to private holders, reversing the trend of at least the last forty years of monetary history. Article 4 (f) of the European Payments Union Agreement provided that "Each Contracting Party shall use its best endeavors to ensure that abnormal balances in the currencies of other Contracting Parties are not held by banks other than central banks or otherwise placed so that they are excluded from the calculation of bilateral surpluses or deficits". Similar provisions might be made in the new Fund Agreement to prevent countries from eluding their minimum deposit requirement by excessive transfers of international reserves to private banks.

Stamp (34), former Advisor to the Governors of the Bank of England, British Alternate Executive Director of the Fund from 1951 to 1953, and Director of the Fund's European Department from 1953 to 1954. Mr. Stamp would also favor the channelling of part of the IMF credits through the IBRD, through the International Finance Corporation, and even through private corporations. He also proposes to explore further the possibility of using collateral pledges of commercial bills, Treasury bills, tax revenues, etc. as guarantees of the Fund's loans and a more active and flexible use of the interest rate weapon as an instrument of policy. The other parts of Mr. Stamp's article and the suggestions presented by Sir Oliver Franks in his 1958 annual statement to the shareholders of Lloyds Bank rejoin very largely the proposals developed in the present study and previously outlined in *Europe and the Money Muddle*.

E. *Other Suggestions*

The acceptance of the basic reforms proposed above should eliminate all existing balance of payments grounds for permissible discrimination under the GATT. This should constitute a powerful incentive for U.S. support of these proposals, as the United States has long been the main target of such discrimination by other countries.

The gradual liberalization of remaining trade, exchange and tariff restrictions could also be given a new impetus by these reforms if they were allied to a continuous and world-wide negotiation of *reciprocal* liberalization commitments, similar to that successfully undertaken regionally by the OEEC on the basis of the EPU Agreement. Prospective credit assistance by the Fund to countries in difficulty should help spur the acceptance and implementation of such commitments by members. Yet, the OEEC experience also suggests that members will insist on retaining the right to invoke escape clauses whenever such assistance is either insufficient or inappropriate to meet their deficits. As in OEEC, a joint examination of the overall policies followed by the member should

(34) Maxwell Stamp, "The Fund and the Future", in *Lloyds Bank Review*, October 1958, pp. 1-20.

be undertaken in such cases and lead to agreed proposals for monetary rehabilitation and stabilization and for the restoration of the liberalization measures reciprocally accepted by all Fund members. Ideally, the Fund should be given the right to disallow, after one year for instance, continued recourse to such escape clauses if it deems them to be no longer justified. Such a decision might entail automatically the right for the country in question to allow fluctuations in its exchange rate as long as its gross reserves remain inferior to, let us say, 30 per cent of annual imports.

Finally, some fundamental reforms in the cumbersome administrative machinery of the Fund have long been overdue. Greater efforts should be made to preserve effective contacts at all levels between the Fund and the national administrations of its members. Periodic meetings of high-level representatives, currently entrusted with monetary policy in their own country, should determine the broad lines of the Fund's policy and the limits within which decisions can be delegated to permanent representatives or to the Fund's management itself. The OEEC and EPU experience should serve as an invaluable guide in shaping up such reforms in more concrete terms.

These, and other questions, could not be fruitfully explored within the scope of the present study (35). Actual possibilities for agreement can only be discovered through the process of international negotiation itself. The results of such a negotiation would certainly differ, in many respects, from the proposals outlined above. It is most likely that the final compromises that prove feasible on a world-wide scale will remain substantially short of the broad and bold aims and techniques suggested here, and of what might be agreed to within smaller groups of countries, more closely interdependent on one another, keenly conscious of this interdependence, and more willing to trust one another's policies and commitments. I shall thus consider below the way in which the agreements which prove feasible on a world-wide level could be supported and supplemented by regional agreements of a similar, or more ambitious, nature, particularly among the OEEC and the EEC countries. This discussion will be far briefer, however, as it involves very largely a mere adaptation to a more limited geographical framework of

(35) See *Europe and the Money Muddle*, pp. 109-138 and 294-301.

the suggestions outlined above, and as I have already developed elsewhere in greater detail the possible shape of future European monetary cooperation and integration (36).

V. Regional Monetary Cooperation in OEEC

The outstanding success of the European Payments Union in helping its members move from bilateralism to convertibility or near-convertibility was eloquently demonstrated by the joint convertibility decisions of last December. Paradoxically enough, this very success sounded the death knell of the EPU itself. It did, however, bring out very suddenly from the limbo where it was waiting for the sound of the convertibility trumpets the European Monetary Agreement laboriously negotiated three and one-half years earlier among the seventeen countries of the OEEC.

The European Monetary Agreement

The EMA constitutes an imaginative attempt to preserve into the convertibility era some of the elements of the regional monetary cooperation previously embodied in the EPU Agreement. This required drastic and long overdue readjustments in the EPU system.

First and foremost, bilateral accounts among central banks had long ceased to provide a valid and automatic criterion of a country's borrowing needs or lending ability. The EPU system of so-called automatic credits was therefore abandoned and replaced by provisions for discretionary credits, financed by a European Fund of $600 million.

The second, and most intricate, part of the European Monetary Agreement consisted in a complete overhauling of the multilateral system for settlements initially established by EPU. This system

(36) See particularly:

a. "Système et Politique Monétaires de l'Europe Fédérée", in *Economia Internazionale*, Vol. VI, No. 1, Genoa, 1953;

b. *The Future of the European Payments System*, Wicksell Lectures, May 1958, Stockholm; and

c. "La Monnaie et le Marché Commun - Politiques Nationales et Intégration Régionale", in *Cahiers de l'Institut de Science Economique Appliquée*, No. 74, December 1958, Paris.

involved the full and automatic compensation, at the end of each month, of all debts and claims accumulated during the month by each member country vis à vis each of the others, and their consolidation into a single net debt or net claim vis à vis the EPU itself, which was then settled partly through EPU credit accounts and partly through gold or dollar transfers. In the early days of EPU, the balances notified to the Agent at the end of each month by the European central banks had been accumulated by them during the month under the operation of bilateral payments agreements eschewing all private transactions on the exchange markets. Free exchange markets had been gradually reopened in the intervening years, however, and multilateral arbitrage agreements substituted in most cases for bilateral payments agreements. By 1958 the largest portion of the balances communicated monthly to the Agent thus resulted from the stabilization inteventions of central banks in the market rather than from direct bookkeeping transactions between them. The European Monetary Agreement registered explicitly this evolution, while still leaving room for bilateral agreements with the few countries whose currencies remained technically inconvertible.

The crucial change introduced by EMA in the EPU system of multilateral settlements lay in the fact that the central banks are no longer required to bring into the monthly compensations all the balances acquired during the month. They may, at their own discretion, bring such balances into compensation or retain them as part of their monetary reserves. Some change of this sort was, of course, well nigh unavoidable as a consequence of the restoration of convertibility in Europe. One could hardly allow European central banks to retain convertible U.S. dollars or other non-member currencies, but forbid them to keep convertible pounds or Deutsche marks as a component of their monetary reserves. Yet this return to a multi-currency gold exchange standard carries with it very real dangers for future monetary convertibility and trade liberalization. Now as in the 1920's, sudden shifts from one currency into another or into gold may endanger the position of the key currencies actually used as foreign exchange reserves by central banks. Moreover, some countries might again, when they run into difficulties, be tempted to use promises of trade concessions or threats of trade restrictions as a weapon to induce other countries to accumulate their currency or to spend it exclusively within their own currency area.

The chief contributions to European monetary cooperation retained in the EMA are its moderate provisions for short or medium term balance of payments credits (37) and, most of all, the provision of an exchange rate guarantee, in terms of the U.S. dollar, for all foreign exchange balances accumulated by members in the currencies of other members. This indeed is the main practical significance of the mulilateral settlements machinery theoretically salvaged by EMA from the EPU Agreement. Each country must notify official buying and selling rates for its currency in terms of the U.S. dollar, valid until further notice, and at which it undertakes to settle at the end of each month the net balance of the bilateral claims or debts reported by members for settlement. These rates may be modified at any time by the country concerned, but, in this case, the claims and debts outstanding at the time of the change will be settled on the basis of the rates previously in force. This is, in practice, the only reason which members might have to make use of the EMA machinery for settlements, since in all other cases the official buying and selling rates at which the EMA operates would be less favourable to them than the rates at which the currencies in question could be bought or sold instead on the exchange market (38).

Proposals for a European Clearing House or Reserve Fund

The European Monetary Agreement should primarily be regarded as an invaluable, if limping, compromise between conflicting points of view as to the future monetary organization of Europe. Many of its shortcomings, however, bear the marks of past, rather than current, divergencies of views between the United Kingdom and some of its main partners on the Continent. Britain was toying in 1955 with the idea of establishing a flexible exchange rate for the pound or, at least, widening considerably the margin between buying and selling rates. Its main opponent on this point, as well as on others, was Switzerland. The United Kingdom's authorities seem now to be satisfied with exchange rate stability and narrow exchange margins, and Switzerland has become the main ally of the United Kingdom in its differences with the European Economic Community over the formation of a European Free Trade Area.

In view of these fundamental changes in member countries' policies, the 1955 European Monetary Agreement would hardly have been put into operation in December 1958 without substantial revisions, except for a series of unforeseen events which left little time or hope for a successful renegotiation. A fundamental, and long overdue, revision of the EPU Agreement had been repeatedly postponed pending the results of the Free Trade Area discussions. When the latter finally collapsed in December, the maintenance of EPU in its then existing form became more anachronistic than ever, but the liquidation of EPU automatically entailed, under the 1955 Agreement, the simultaneous entry into force of the European Monetary Agreement. Final action was precipitated by the French decision to readjust and stabilize their own monetary and exchange system preparatory to the first round of tariff and trade liberalization of the European Economic Community on January 1st.

This hurried time table and the bitter atmosphere resulting from the breakdown of the Free Trade Area talks precluded any further negotiation of an EPU or EMA revision at that time. Yet, the need for such a revision had been clearly affirmed in all the Maudling Committee discussions. The EPU Managing Board had been instructed to explore the problem, and had already presented preliminary reports to the full committee. There is little or no doubt that the present EMA system will require substantial modifications if and when the European Economic Community and the other OEEC members succeed in patching up their differences, and agree on some new form of economic association among the seventeen OEEC countries. The mutual commitments to be undertaken by members in the trade field would be more ambitious than those of the OEEC Code of Liberalization, and would have to be supported by correspondingly strong commitments in the money and payments field.

(37) In addition to the European Fund loans already mentioned, members also undertake to grant each other, under the name of "interim finance", small overdraft facilities repayable within the month.

(38) No balances indeed were reported for settlement in the first monthly operations (for January 1959), except by four countries still operating under bilateral payments agreements. Net payments totalled only about $2 million, as compared with $300 million in the last month of EPU's operations.

The above summary of the European Monetary Agreement is a highly condensed and simplified one. For a fuller account, see the official text and accompanying memorandum of the Secretary General of OEEC — released by OEEC in August 1955 — and my own discussion in *Europe and the Money Muddle*, pp. 220-233 and 280-284.

The keystone of such a reform of the present EMA would bear a close similarity to the proposals advanced above for the reform of the IMF. The project would be regional, rather than world-wide in scope, however, and could probably be negotiated and implemented more easily, more rapidly and more fully within such a framework.

The participating countries would establish jointly a Clearing House centralizing all payments among their separate central banks. These payments would be effected through corresponding debits and credits to the account maintained by each central bank with the Clearing House.

These clearing accounts would be fed, first of all, by the compulsory transfer to each country's account of any and all balances in another member's currency purchased from the market by its central bank or credited to it by another central bank. They could be fed, in addition, by transfers of gold, or convertible currencies of third countries, or even of other currencies specified by the Clearing in the light of its members' current demand for such currencies. The first of these two provisions would be designed both to simplify payments among members and to prevent any relapse into open or concealed bilateralism among them.

The clearing accounts would, of course, be fully convertible and could be freely drawn upon by their holders to make payments to third countries as well as to member countries. They would, moreover, carry an exchange guarantee in terms of a jointly agreed unit of account. This unit might, as in the case of the IMF, be defined merely and simply in terms of gold. A less rigid, and on the whole preferable, procedure might be to revive a unit similar to the former EPU unit of account, *i.e.* tantamount in effect to an exchange guarantee in terms of whichever European currency will in fact remain stablest in the future with respect to gold itself (39).

(39) Such a clause would have the same effect as a gold guarantee unless *all* member currencies modified *in the same direction* — upward or downward — their present parity with respect to gold. The application of a gold clause in such an event would probably result in unjustified windfall losses or gains for the debtors and creditors in the Clearing. It might be noted that the elimination of the EPU unit of account by EMA and its substitution by a gold clause for some transactions and a dollar clause for others would open a serious and unsolved question in the improbable event of a change in the United States gold price or gold policy. A whole article (Article 14), entitled "Modification in the United States Price or Policy for Gold", is devoted to this very problem, but its call for an urgent and comprehensive review of the Agreement in such a case is only a thin disguise for a total lack of agreement at this stage as to the way in which the situation should be handled. The needless introduction of such complications and uncertainties in the Agreement is difficult to explain except on the basis of British fears that the EPU might enjoy greater prestige than the pound sterling, displacing it gradually as a key currency in world trade and payments.

The participating countries might be required, at least initially, to maintain in their clearing account a minimum balance equivalent to, let us say, 10 or 20 per cent of their total gold and foreign exchange reserves. Based on current reserve levels, these required balances would total today as much as $2 billion if a 10 per cent "reserve requirement" were adopted. The resources thus placed at the disposal of the Clearing would be totally unaffected by intra-European disequilibria, since any decrease in some countries' global reserves and minimum deposits would then be exactly offset by corresponding increases in other members' reserves and required deposits. The resources of the Clearing would fall only as a consequence of global deficits of the OEEC area as a whole toward the rest of the world, and even then by only 10 per cent of the amount of such deficits. A cumulative deficit of $10 billion would be necessary, for instance, to reduce by one half the funds initially placed at the disposal of the Clearing. Such an evolution would be highly improbable, and would in any case call for joint readjustment policies in order to harmonize the European pace of monetary and credit expansion with that of other areas, or for preserving a desirable pace of expansion against the impact of outside deflation through the negotiation of foreign credits or through an increase of restrictions on trade and payments with non-member countries.

The resources of the Clearing would be held primarily in gold and convertible foreign currencies, so as to enable it to maintain the world-wide convertibility of its members' accounts. The factors of stability underlined above, however, would make it possible for the Clearing — just as for any bank — to reinvest at short or medium term, within or outside the OEEC area, a reasonable portion of its assets without endangering thereby the effective liquidity of its deposits for their individual holders.

The lending procedures of the Clearing would follow the same general pattern outlined above with respect to the IMF. The criteria determining the overall amount of such lending, however, would be different, and far less automatic in character. The total amount of assistance provided to members would have to be adjusted in

the light of the current inflationary or deflationary pressures within the area and of the evolution of the balance of payments and monetary reserves of the group as a whole toward the outside world. This would not, of course, ensure that the policies of the group as a whole would be wiser than those of other countries or than those which would have been independently followed otherwise by its national member states. The group's policies might be more inflationary or more deflationary, as well as less inflationary or less deflationary, more foolish as well as wiser, than those pursued in the rest of the world. The choice of policies open to it would merely be wider and freer than that otherwise available to its individual members. It should certainly be exercized in such a way as to preserve freedom of trade within the area, and strengthen its ability to follow liberal policies toward the rest of the world as well. The latter result could not be guaranteed, however, in the absence of a sufficient coordination of policies and mutual financial assistance between the group and other major trading countries. Important tasks would thus continue to devolve on world-wide organizations such as GATT and the IMF, even though effective performance at that level is likely to develop more slowly and gradually than will prove feasible at the regional level.

As in the case of the IMF, the influence and means of action of the Clearing would be likely to grow at a rapid pace, as experience overcomes initial diffidence toward the system and the inertia of old habits and traditions. Its deposit accounts, particularly, might be expected to exceed largely, after a time, the minimum requirements initially adopted and even, possibly, to make these unnecessary. Those accounts should indeed prove highly attractive to member banks in view of the unique guarantees attached to them. The convertibility and exchange rate guarantees provided would eliminate the risks of unilateral inconvertibility or exchange rate devaluation inseparable from the current investment of monetary reserves in national, so-called "key" currencies. Default risks, moreover, would be practically eliminated by the obligation accepted by all members to channel through the Clearing all payments due by anyone of them to another. The overdrafts of a defaulting borrower would thus be automatically amortized by the transfers made to its account by any other member, and this procedure would not be dependent on the good faith of the borrowing country itself, but

on the commitments subscribed to by all other members of the Clearing.

Finally, the Clearing might attract similar accounts even from central banks of non-member countries whose payments relations are largely with the EPU area. Indeed, nearly 40 per cent of non-EPU countries' merchandise imports originate in the EPU area, and this proportion exceeds 50 per cent for the countries outside the dollar-area. The European Clearing, based on a close alliance between sterling and other European currencies would tend to develop gradually into a powerful monetary center, susceptible to assume an international role comparable to that of London before 1914, but which London alone has become too weak to perform today. Non-member countries could be expected to transfer gradually into clearing accounts some portion of the national currency balances now held by them as monetary reserves. Insofar as these balances are now held in non-member currencies — *i.e.* practically in U.S. dollars — this would strengthen the gross reserve position of the Clearing and result in some further expansion of its lending capacity. Insofar as they are now held in member currencies — practically pounds sterling — it might help smooth out the impact now exercized upon the debtor of such balances — practically the United Kingdom —by fluctuations in their overall amount. The largest portion of these fluctuations would indeed by associated with the settlement of imbalance between the owners of the balances and the European area itself, and would not cause any drain on the Clearing's gold and dollar reserves, nor any change in its other assets, but merely a reshuffling of its net claims or debts vis à vis the United Kingdom on the one hand, and its other members on the other. While persistent movements of this sort in the same direction would obviously require in the end cash settlements among the member countries concerned, a great many of them could properly be cushioned by the Clearing and help avoid or smooth out the undesirable pressures which they would otherwise exercize upon these countries' policies.

A European Clearing House would therefore be able to offer a substantial contribution to the preservation of international liquidity and to the reduction of the dangers attendant to the use of national currencies as international monetary reserves. It could not, however, solve such world-wide problems as fully and effectively as a revised IMF might do. The proposals advanced in this Section,

therefore, should not be regarded as a lasting substitute for the IMF reforms discussed in Section IV. On the other hand, neither should a global IMF approach be regarded as a full substitute, making a European Clearing superfluous and useless. First of all, the setting up and implementation of a fully satisfactory IMF system will probably require several years of negotiations and experimentation. Secondly, the management of a world-wide monetary clearing system, and particularly the investment of the large funds derived from its operation will present enormous administrative and political hurdles, which can best be surmounted through some decentralization of the decision-making process. Finally, the high degree of economic and political interdependence of the European countries (40) and their experience of past cooperation are likely to make feasible far more extensive regional trade liberalization, credit commitments and policy harmonization among them than could conceivably be negotiated and implemented on a world-wide level.

The practical feasibility of a European Clearing Agreement, however, is intimately bound up at this stage with the renewal of OEEC negotiations for a European Free Trade Area or Economic Association. Persistent conflicts of views subsist in this respect and make the final outcome highly uncertain. The French protectionist objections which contributed so much to the breakdown of past negotiations may gradually abate if the remarkable success achieved to date by the French monetary and exchange readjustments of last December are confirmed and consolidated. The resurgence of French nationalism today, and possibly of German nationalism tomorrow, may also weaken the political unity objectives of the Six countries of the European Economic Community and remove other sources of opposition to a broader, but looser, European Economic Association. On the other side of the Channel, influential circles are already arguing in favor of a full-fledged adherence of the United Kingdom to the European Economic Community itself, as it stands today.

None of these trends, however, is sufficiently pronounced to permit any easy prediction of future developments. The European Economic Community exists, not only through the measures and institutions provided for in the Rome Treaty, but also through the

(40) About three-fourths of the OEEC countries' total exports are directed to each other and their overseas monetary areas.

myriad of decisions taken by individuals and firms — within and outside the Community itself — to adjust their economic activity and investment plans to the new horizons opened by it. Vested interests will increasingly combine with political ideals to resist any dilution of the Six' progress toward economic integration and federal unity.

The most realistic and constructive solution of these dilemmas would seem to lie in a parallel drive toward both sets of objectives. Whatever degree of cooperation and liberalization can in fact be achieved among the seventeen OEEC countries should be exploited to the full, but without being allowed to develop as a brake on the closer integration which can realistically be aimed at within the European Economic Community. The gradual adaptation of our legal economic institutions to the facts of international economic interdependence can be carried forward most easily and successfully if we recognize the complementary — rather than the competitive — role that may be assigned to overlapping regional groupings in this respect. The six countries of the Community have indicated their readiness to accept a far closer integration than would be acceptable to the seventeen countries of OEEC, just as the latter may accept broader and firmer commitments to each other than they would be ready to extend to the world at large through GATT or the IMF.

The ensuing discussion of monetary integration among the six countries of the European Economic Community is based on this philosophy. The exact line of demarcation between the institutions of the Community and those of a future European Economic Association cannot be predicted at this stage and should, in any case, fluctuate over time as the future success of integration policies prompts the acceptance of closer commitments and surrenders of sovereignty by the seventeen OEEC countries as well as by the six Community countries.

VI. Monetary Integration in the European Economic Community

The adoption of the IMF and EMA reforms suggested above would go a long way toward providing the European Economic Community with a stable monetary framework and facilitating the

adoption of liberal policies by the Community toward the rest of Europe and toward the outside world. Yet, a number of factors, specific to the Community itself, must be taken into account for the shaping up of its future monetary policies and institutions.

First of all, the commercial commitments of members have already been negotiated and spelled out in considerable detail in the Rome Treaty, together with a number of other provisions designed to harmonize competitive conditions throughout the Community.

Secondly, these commitments are far more drastic and rigid than those which are likely to be negotiated within the broader framework of GATT or the IMF, or even of the OEEC group as a whole. Correspondingly stronger commitments in the monetary and financial fields will be necessary to ensure a coordination of the members' internal policies sufficient to preserve long run equilibrium in their balances of payments without resort to trade and exchange restrictions outlawed by the Rome Treaty.

Thirdly, a further evolution of the Community's monetary institutions may possibly be called for, in the long run, if the success of the economic integration measures already accepted encourages further progress toward political, as well as economic, integration among the six countries of the Community. The institutional framework to be adopted in the early stages of the Community's life should be flexible enough to facilitate, rather than hamper, such an evolution. On the other hand, the tasks already assigned to the Community's authorities by the Treaty of Rome are so vast and formidable as to deserve their full attention and energies in the immediate years ahead. The most elementary wisdom and caution will warn them against any premature injection of controversial and divisive issues relating to hypothetical hopes and far-distant blueprints upon which there does not exist at present a sufficient basis for agreement among the participating countries.

The suggestions outlined below should be read in this light. Some of them may be immediately relevant and applicable, while others could only be negotiated and implemented if a protracted period of successful experimentation with less ambitious aims and techniques of integration induces the six countries to press further ahead the gradual merging of their separate administrative and political powers and responsibilities for monetary management.

Monetary Integration through the Disciplines of the Market

Proponents and adversaries of economic integration generally agree on one point: a real integration presupposes the acceptance by member countries of substantial surrenders of national sovereignty. Incontrovertible as it is, this observation also suggests a totally misleading interpretation of the political options actually available to the national authorities of a country. National sovereignty is always subject to stringent limitations, resulting from economic imperatives and independent of any integration agreements or international commitments. One of these imperatives, of particular relevance to the issues to be discussed presently, is the unavoidability of overall balance in a country's external transactions. Deficits in current account must necessarily be balanced by capital imports, and surpluses on current account by capital exports, regardless of the national policies pursued.

The national authorities of a deficit country cannot therefore escape the following alternatives. First of all, they may be able to finance these deficits by drawing down international assets previously accumulated by the country, but only to the extent that such assets exist and — in the case of private assets — only insofar as their liquidation can be effectively controlled or influenced by the national authorities. Alternatively, they may be able to finance the deficits through the importation of foreign capital, but only within the limits resulting from the foreign lenders' willingness to lend and from the acceptability of the conditions, financial and political, attached by them to these operations. The maximum size of the current deficits will thus be unavoidably limited by the maximum size of these feasible capital imports and liquidation of assets. Beyond this, the national authorities will have no choice but to reduce the deficits to the level of available finance. In the absence of any international commitments' three methods — and three methods only — will be open to them. The first will be to modify their international monetary policy — in the broadest acception of this term — in such a way as to adjust the country's overall demand for goods and services to its productive capacity *plus* the excess imports whose financing can be assured by the means outlined above. This may not suffice to restore external equilibrium at high levels of employment and economic activity if the relation of internal costs to costs abroad is such as to dampen export demand

and stimulate an excessive demand for imports. The readjustment of cost disparities would require in this case either a reduction of internal cost elements — especially wages — or, more probably, a lowering of exchange rates. This may be avoided, however, at least temporarily, through export subsidies, increases in import duties, or quantitative trade and exchange restrictions.

International agreements will usually involve some sacrifice of sovereignty with respect to the use of subsidies, of tariff and other restrictions, and possibly of exchange rate readjustments. On the other hand, they will also guarantee the country against the shocks to its economy resulting from the resort to similar techniques by its trading partners. They may also enlarge the scope of available external financing through official credits, mutual aid, or merely the stimulation given to private capital imports by the guarantees provided against exchange restrictions or devaluation. The limited sacrifices of sovereignty involved in integration agreements may therefore be offset, or far more than offset, by the opportunities which they offer to protect the country's export markets and to attract additional capital to finance temporary, or desirable, deficits on current account.

This is all the more true as the internal policy readjustments which may be required for the implementation of the country's commitments to trade liberalization and exchange rate stability are in any case economically desirable and even unavoidable in the long run. Trade and exchange restrictions, and even exchange devaluation, offer only a temporary escape from the economic imperatives to which any country is subjected, irrespective of its legal international commitments. Restrictions may be used to adjust a country's import level to its export proceeds, but persistent inflationary policies would reduce the latter to a mere trickle in the end, because of their impact upon the country's internal prices and production costs. Devaluation would become inescapable at some point to restore an export level sufficient to finance even the most essential import needs. But again the internal prices increases and external currency depreciation brought about by a failure to readjust internal inflationary policies would inevitably lead in the end to a total monetary collapse (41).

(41) I cannot resist the temptation to quote here the following lines from a comedy of Jacques Deval: " Qui croit fuir son destin est seulement attaché à une corde plus longue... Mais au bout de la corde, ... nous faisons tous librement ce qu'il était fatal que nous fassions ". Countries will most often adopt " freely " in the end the very policies which international agreements would have " forced " them to accept more promptly.

One of the main effects of the trade and exchange commitments explicitly spelled out in the Rome Treaty would therefore be to accelerate the unavoidable impact which market disciplines would ultimately exercise anyway upon a deficit country's policies. The gradual elimination of tariff, trade, and payments restrictions among members, and the adoption of a common, uniform, commercial policy toward non-members will make it impossible for a deficit country to resort to restrictions as a means to balance its external transactions (42). Exchange rate readjustments are not entirely ruled out and might even be recommended at times by the Commission to overcome deep-seated maladjustments in a country's balance of payments and competitive position. Yet, a repeated resort to exchange rate devaluation to offset the incidence of persistently inflationary policies would clearly be incompatible with the Treaty's objectives, and would lead to frequent — even if temporary — distortions in competitive conditions, unacceptable to the country's trading partners. Each Member State is committed to " treat its policy with regard to exchange rates as a matter of common interest " (Article 107) and to " pursue the economic policy necessary to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices " (Article 104).

The final outcome of these Treaty provisions would therefore be to accelerate and strengthen the impact of traditional market forces upon internal policy readjustments for the countries in deficit. The surplus countries, however, are not subject to similar market pressures and financial limitations. They are always free to offset the internal expansionary impact of their surpluses by " neutralization " or " sterilization " policies. By choosing to do so, and refusing simultaneously to finance their surpluses by capital exports, they may throw upon the deficit countries the whole burden of the internal readjustments necessary to the restoration of equilibrium

(42) Although escape clauses allow a country to resort unilaterally to emergency measures in certain cases, the Executive of the Community may impose by means of a qualified majority vote the modification, suspension or elimination of these measures, without the assent of the country concerned.

in the international payments pattern. This " deflationary bias " of the gold standard has often been exaggerated by Keynesian economists, and seems indeed more than compensated today by the " inflationary bias " exercized by pressure groups upon many countries' monetary and fiscal policies. The fact remains, however, that if the harmonization of the member countries' internal policies — *implicitly* required for the observation of the *explicit* clauses of the Treaty relating to restrictions and exchange rates — were left entirely to the disciplines of the market, the latter could only enforce a downward alignment of the more inflationary, or less deflationary, countries upon the less inflationary, or more deflationary, ones. The general pace of expansion of the Community would, in this case, inevitably be set by the least expansionary countries. This is precisely the reason why the sweeping liberalization commitments of the Rome Treaty would have been unacceptable and unnegotiable in the absence of complementary provisions on mutual aid and policy harmonization.

Intergovernmental Cooperation and Policy Harmonization

The broad philosophy underlying the Treaty is that the initial acceptance and later implementation of its liberalization commitments are conditioned by parallel and mutual commitments to coordinate national policies in such a way as to preserve long run equilibrium in the members' balances of payments at high levels of economic activity and employment and stable levels of prices. This philosophy is embedded in various Treaty articles, but its concrete implications are generally left to be worked out, in *ad hoc* fashion, by the institutional organs of the Community.

Article 105 requires the member States to " institute for this purpose a collaboration between the competent services of their administrative departments and between their central banks... In order to promote the coordination of the policies of Member States in monetary matters to the full extent necessary to the functioning of the Common Market, a Monetary Committee with consultative status shall hereby be established with the following tasks:

— to keep under review the monetary and financial situation of Member States and of the Community and also the general payments system of Member States and to report regularly thereon to the Council and to the Commission; and

— to formulate opinions, at the request of the Council or of the Commission or on its own initiative, for submission to the said institutions ".

The authority and effectiveness of the Monetary Committee are likely to be very much enhanced by its composition, realistically made up of high-ranking officials from both the Ministry of Finance and the Central Bank of each of the participating countries.

Article 108 establishes the procedure to be followed when actual or prospective balance of payments difficulties of a Member State are likely to prejudice the functioning of the Treaty. The Commission must, in such cases, examine without delay the situation of such a State and the action taken by it. " It shall indicate the measures which it recommends to the State concerned to adopt. If the action taken by a Member State and the measures suggested by the Commission do not prove sufficient to overcome the difficulties encountered or threatening, the Commission shall, after consulting the Monetary Committee, recommend to the Council the granting of special assistance and the appropriate methods therefor... The Council, acting by means of a qualified majority vote, shall grant mutual assistance; it shall issue directives or decisions laying down the conditions and particulars thereof... ".

Finally, if all these measures prove insufficient, " the Commission shall authorize the State in difficulties to take measures of safeguard of which the Commission shall determine the conditions and particulars ". Article 109 even authorizes Member States to take such measures " provisionally " if a sudden crisis occurs and if decisions are not reached immediately with respect to mutual assistance (43). In either case, however, the Council may, by means of qualified majority vote, force the State concerned " to amend, suspend or abolish the measures of safeguard referred to above ".

These meetings and consultations may reasonably be expected to exercize in time a growing influence upon the necessary harmonization of member countries' internal policies. The views or recommendations they may express in this respect, however, are in no way binding. Divergencies of national policies may therefore persist

(43) Such independent action by a Member, however, can no longer be taken after the end of the transitional period with regard to its trade with non-member countries.

up to the point where market forces themselves compel deficit countries to readjust their policies, as the exhaustion or near-exhaustion of their monetary reserves make it impossible for them to finance further balance of payments deficits. Mutual aid credits may postpone this day of reckoning, but such credits can only be granted *by other Member States, subject to the agreement of the latter*. Cases may therefore arise when mutual aid financing is unanimously recognized as desirable and urgent, but may be delayed unduly, or even blocked, by a lack of agreement about the most appropriate sources of such financing. This would be most likely to induce a recourse to the Treaty's escape clauses, unnecessary otherwise, and highly detrimental to all concerned.

A more effective advance planning of mutual assistance financing would seem highly desirable from this point of view alone. It might also help give more weight to the Community's recommendations for policy harmonization and facilitate the gradual acceptance of presumptive criteria, agreed to in advance, and delimiting the respective scopes of independent national action and minimum harmonization requirements in the broad field of monetary and financial policies. Such *ex ante* harmonization would obviously be far preferable to a mere *ex post* harmonization adopted only after considerable damage has been done, and under the pressure of an acute crisis in member countries' balances of payments.

The suggestions outlined below are directed at these two problems. Once again, however, they raise delicate issues on which agreement could not be reached easily without protracted studies and reflexion. Fortunately, the strong reserve and balance of payments position which now characterizes all the Community countries gives them ample time for such consideration (44). There is little doubt that further agreements will have to be concluded in the future to harmonize the monetary institutions of the Community and its international payments machinery with the far-reaching commitments already accepted by it in the field of commercial policy.

(44) The monetary reserves of the six countries, as reported in *International Financial Statistics*, have risen from $3.8 billion in 1950 to $10.1 billion in 1957 and $12.6 in 1958, and their gold and dollar holdings have increased by $2 billion in 1958 alone, from $8.8 billion to $10.8 billion. The six countries together have current account surpluses with the rest of the world, ranging from $600 million to more than $2 billion a year, in every one of the last six years without exception.

A European Community Reserve Fund

The plan previously outlined for a European Clearing House or Reserve Fund would be particularly adaptable to the needs of the European Community. Minimum deposits with a European Community Reserve Fund could provide the easiest and most rational source of financing for mutual credit assistance without endangering in any way the liquidity requirements of the lending countries.

If minimum deposit requirements were to be calculated on this basis alone, a 10 per cent level in relation to gross monetary reserves would endow the Community with an initial working fund of about $1.2 billion, ample to meet any conceivable needs for a considerable time to come. It would be desirable, however, though not essential, to foresee from the beginning gradual increases in this ratio, and this for two reasons. The first is to streamline the relationships which might later be established with a reformed IMF or with the European Clearing House envisaged in the preceding sections of this paper. The Community should ideally participate in either or both of these two institutions as a single unit rather than as a separate collection of individual countries. International credit needs of its members should normally be handled and financed by the Community itself, and involve no transactions with either the IMF or the European Clearing House. The need for such transactions would arise only if the Community Reserve Fund ran short of non-member currencies, or if non-member countries ran short of Community currencies, and if these disequilibria called for legitimate cushioning finance rather than for — or in conjunction with — corrective policies on the part of the countries concerned.

Such a scheme of organization would help decentralize the complex negotiations involved and keep in the hands of the Community itself the leverage necessary to promote the desired harmonization of its members' monetary, financial and economic policies. Deposits with a reformed IMF or with a European Clearing House should thus be maintained by the Community Reserve Fund itself, rather than separately by each of the participating countries. The Community Reserve Fund would, however, have to be increased in such a case beyond the level mentioned above, so as enable it

to maintain the required deposits with the IMF or the European Clearing.

The institution of such a Fund would not entail, of itself, any new and spectacular step toward supranational mechanisms in the monetary field. Its methods of operation could be substantially similar to those suggested above for a wider OEEC Clearing House, except insofar as the Rome Treaty already provides that mutual assistance may be granted by a qualified majority vote of the Council.

Yet, it would be desirable to organize the Fund in such a way as to facilitate some later and gradual shifts of authority and responsibility, in the monetary field, from national institutions to Community institutions.

The experience gained in the initial years of operation of the Monetary Committee in the early detection and readjustment of excessive inflationary or deflationary tendencies in the economy of member countries could, for instance, lead to the definition of presumptive criteria, or danger signals, justifying a stronger intervention of the Community to elicit more rapidly the necessary corrective measures and attempt to forestall *ex ante*, rather than cure *ex post*, foreseeable crises in member countries' balances of payments. It is doubtful indeed whether the Treaty could, in the end, stand the strain of frequently recurring crises of this sort.

The criteria adopted might be based, for instance, on the amplitude and persistency of changes in employment, economic activity, bank credit, public debt, money supply, prices, monetary reserves, etc. They might initially serve merely to bring automatically into motion a special scrutiny, by the consultative organs of the Community, of the policies followed and of the need for action either by the country itself, or the Community, or both. In the course of time, closer integration might be institutionalized through the adoption of similar criteria as ceilings on independent national decisions. National central banks might, for instance, agree to some presumptive annual ceiling on the growth of their internal credit assets in general, or of some special categories of such assets regarded as particularly open to abuses. Transactions beyond the agreed ceilings might have to be specifically approved by the Commission or the Council, acting upon the recommendations of the Monetary Committee.

The provisions discussed so far all refer to a "downward" harmonization of national "inflationary" policies. An attempt

should be made to build up similar safeguards against national "deflationary" policies, affecting unfavourably the balance of payments of other members and slowing down unnecessarily their own rate of expansion. The minimum deposit requirements of members with the Reserve Fund might be raised upon that portion of their monetary reserves which exceeds some pre-agreed benchmark corresponding to "normal" reserve requirements. Deposits widely in excess of such requirements might be subject to funding into medium or long term securities. Provisions might also be made, in such cases, for a levelling down of discount or interest rates in order to encourage desirable credit expansion. Simultaneous increases in abnormally high reserve levels and budgetary surpluses might even ultimately justify directives to the member concerned to either lower taxes, or increase expenditures, etc.

These two issues — *i.e.* the control of "inflationary" or "deflationary" national policies — inevitably raise the problem of defining the desired level of policy harmonization with respect to which these "undesirable" developments can be characterized and measured. Possible divergencies of views among member countries in this respect will necessarily have to be arbitrated here in the light of the development of the balance of payments of the Community as a whole with the rest of the world.

The huge balance of payments surpluses and reserve accumulation of the Community in recent years should make possible the resumption of a relatively fast pace of expansion, together with liberal external trading policies and with a substantial level of capital exports toward the underdeveloped countries, particularly in Europe and its associated monetary areas.

The opposite situation, however, should also be envisaged. Balance of payments deficits with the rest of the world might possibly develop at a later stage as a result of restrictive policies abroad, or of a faster rate of financial expansion in the Community than in the rest of the world. Joint decisions on the part of members would be necessary in this event in order to strengthen their position in international negotiations aimed either at reversing such trends abroad or at obtaining cushioning finance for temporary deficits. They would be even more necessary if the failure of such efforts forced the Community to choose between a slowdown of its own rates of expansion, or a modification of its currencies'

parities, or a tightening of its joint tariff, trade and exchange restrictions toward non-members.

Such are the considerations that will have to determine in the end the average expansion pace and monetary policies of the Community, and influence its ability and willingness to grant mutual aid to individual members in difficulty. They are also likely to impose gradually upon its members a more effective machinery for the adoption and implementation of such joint policies than is now contemplated or than is either necessary or possible in the immediate future. A European Community Reserve Fund could become a powerful instrument to bring about the fuller integration of monetary policies that will ultimately be required by the formation of a single trading area, free of internal barriers, and by the conduct of a uniform commercial policy with respect to the external relations of the Community.

Monetary Unification?

An eventual merger of members' national currencies into a single Community currency can only be regarded as highly hypothetical at this stage, and should in any case be envisaged only as the ultimate step of a monetary integration process. It must be emphasized that its desirability as well as its difficulties are essentially political rather than economic. Economically, indeed, a full currency merger would differ very little from a system of free and stable exchange rates among the national currencies of the participating countries. The discipline and limitations which it would impose upon national policies would be practically identical in both cases. If anything, full currency unity would make this discipline less, rather than more, stringent because it would stimulate an even larger flow of cushioning capital movements to finance temporary disequilibria. The reason for this revolves, in turn, on the one major difference between the two systems. National commitments to exchange rate stability may always be reviewed and revoked, at a later stage, by the national authorities. Even an international agreement might be modified by common consent or broken by a country in difficulties. A currency merger, on the other hand, would be very nearly irrevocable and irreversible in practice. This irreversibility constitutes a strong argument against a premature merger. It would probably be unwise to close the door as fully

and definitely to exchange rate readjustments until the impact of the Rome Treaty's commitments to trade liberalization has been absorbed and until experience has demonstrated the feasibility and success of the coordination of internal monetary and financial policies throughout the territory of the Community.

We have already discussed above most of the institutional reforms through which such coordination should gradually be implemented and consolidated in any case, irrespective of the final step toward currency unity. This final step itself, if not undertaken prematurely, would not raise any great difficulties. Three types of measures would help smooth out the transition.

The first would be to authorize and encourage the use of the European unit of account (45) in all international, and even national, capital transactions throughout the Community's territory. This would contribute to the revival of the capital markets still paralyzed or handicapped today by fears of exchange rate instability.

The second step would be the adoption by all member countries of new basic national monetary units identical in value to the European unit of account. Each currency would still retain at this stage its own separate entity and be issued and redeemed by its own national central bank. Since all six currencies would now be equivalent in value, however, they could easily circulate at par throughout the area of the Community and be accepted in payments outside the issuing country's borders. Foreign notes returned by traders to the central bank of the country in which they had been received in payment would be redeemed by the issuing bank, the settlement being immediately effected through respective credits and debits of the clearing accounts of the two central banks concerned with the Community Reserve Fund. This intercirculation privilege would bear a close resemblance to the old Latin Union which similarly ensured for many years before the first world war the intercirculation of silver coins whose metallic value diverged substantially from their nominal value (46). Any subsequent ex-

(45) See above p. 178 and footnote.

(46) This historical precedent would suggest the adoption of national units — and of a European unit — equal to one fifth of the present gold content of the U.S. dollar. This would restore the traditional relationship of most continental countries to the U.S. dollar, such as was preserved throughout the nineteenth century on the basis of the famous "germinal" franc. If, as now appears likely, the currencies of the Six are finally stabilized on the basis of their present exchange rates, the proposed new unit would be exchanged practi-

change rate readjustment would inevitably deprive the currency concerned from the intercirculation privilege. This would act as a powerful deterrent to such readjustments and reinforce exchange rate stability as an important goal of economic policy for the six countries of the Community.

The final stage of monetary unification would then merely require the nominal transfer of the outstanding assets and liabilities of the national central banks to a joint European Monetary Authority. This need not involve any radical alteration in the central banking structure of the Community if all the institutional prerequisites mentioned earlier in this paper had been previously fulfilled. The European Monetary Authority could be organized on a largely decentralized basis, retaining the individuality of the present national central banks as operating institutions for the system, just as the twelve Federal Reserve Banks of the United States carry out in practice all the transactions of the Federal Reserve System. Each national bank would continue to manage its own monetary and credit operations within agreed statutory limits, and under the general supervision of the European Monetary Authority. The statutory rules to be adopted would probably include the setting up of national credit ceilings, to be exceeded only with the approval of the European Monetary Authority, of minimum reserve ratios, and other regulatory techniques inspired from present central banking legislations in the Community and abroad, and from the experience acquired by the European Community Reserve Fund and the Monetary Committee.

An equitable distribution of the burden associated with the maintenance of adequate reserve levels of gold and foreign exchange by the Community as a whole would probably require that each national bank observe some minimum prescriptions with regard to such holdings. These might be met at the outset through the negotiation of initial, interest-bearing, stabilization loans, at long or medium term, by the low reserve countries, either abroad or with the high reserve countries. Later reserve deficiencies could be met by special advances or investments of the Community Reserve Fund,

cally at par for the new " heavy " French franc, at one to ten for Belgian and Luxemburgese francs, at one to 125 for Italian lire, at one to 0.84 for German marks, and at one to 0.76 for Dutch guilders.

or by open market transactions in approved securities among the participating banks.

The reader will note that many of the substantive aspects of such a reform would already have been put into operation by the Monetary Committee and the Community Reserve Fund, if the institutional prerequisites to monetary unification had been previously fulfilled. This confirms the view, expressed above, that the real significance of monetary unification is political far more than economic. The fundamental problems which should be raised before such a spectacular decision becomes either desirable or possible are:

1) The acceptance of such an irreversible step toward monetary unification as a political goal, dramatizing and consolidating the will of the Six to achieve a full merger of their national economic sovereignties;

2) The development of a sufficient degree of confidence in the feasibility of this objective, on the basis of a protracted experience with a *de facto* harmonization of national policies, the success of which would have been demonstrated by the full observation of the members' liberalization commitments together with the maintenance of exchange rate stability among their separate currencies;

3) The institutionalization of the anonymous market " discipline " involved in this *de facto* harmonization, through administrative rules and procedures, agreed to among members, particularly with reference to the monetization of internal credits by the banking system.

Monetary unification must be conceived therefore as the crowning step of the Six countries' integration policies. It should guide and inspire such policies, but its premature adoption would involve enormaus risks of setbacks which might be fatal to its consolidation and ultimate success.

VII. Summary and Conclusions

1. The European convertibility decisions of last December mark an important step forward on the long road from the international monetary chaos of the last decades toward a new international monetary order. Of and by themselves, however, they merely

return the world to the unorganized and nationalistic gold exchange standard of the late 1920's. The utter irrationality of such a system, and its extreme vulnerability to unfavourable developments in the few " key currency " countries on which it rests, were unanimously denounced by all economists at that time, and the wisdom of these warnings was quickly and catastrophically demonstrated by the collapse of the gold exchange standard a few years later, in 1931.

Inadequate gold supplies are supplemented, in such a system, by a growing accumulation of *national* key currencies as *international* reserves. Such accumulation inevitably centers on the "safest" currencies of major creditor countries and results in " unrequited " capital imports by them. The very countries that should lend to the others are thus unwittingly borrowing short term capital from them. These capital movements do not, by themselves, relieve the gold shortage, but merely disguise it as a shortage of the key currencies in question. In order to contribute to the needed expansion of world liquidity, they must stimulate additional matching capital exports by the key currency countries, or a contraction of their surpluses on current account. Either of these reactions, however, cannot but lead to a progressive and persistent deterioration in their net reserve position up to the point where their currency no longer appears as the " safest " for reserve investment by other countries. The consequent slowdown, cessation, or reversal of the accumulation of key currencies as world reserves then brings back to the fore the underlying gold shortage problem and imposes at the same time difficult balance of payments readjustments upon the center countries of the system. Internal deflation, currency devaluation, or trade and exchange restrictions will be the main choices open to them, will tend to spread from the center countries to the rest of the world, and may be further aggravated by speculative capital movements culminating in a financial panic à la 1931, or/and a relapse into bilateralism.

The recent deterioration of the United States balance of payments, the persistent weakness of the dollar on the exchange markets, the huge gold losses of 1958 and the re-awakening of protectionist forces in the Administration and the Congress would fit this analysis. Heed should be paid to these ominous portents of future trouble before the crisis is upon us.

2. The internationalization of foreign exchange reserves under the aegis of the International Monetary Fund has been advocated

above as the most logical solution of this problem. It would facilitate the adjustment of the Fund's lending operations to the legitimate liquidity requirements of an expanding world economy, and help stabilize the world monetary system against the vicissitudes of national monetary management in the present key currency countries. Concrete measures have been proposed to safeguard such a truly *international* gold exchange standard against the inflationary bias which caused the rejection, fifteen years ago, of the broadly similar proposals of John Maynard Keynes.

3. A workable and viable system of international monetary convertibility will also depend, tomorrow as it did yesterday, on an ample provision of cushioning capital to finance temporary disequilibria, and on the correlative acceptance and implementation of a coordination of internal financial policies sufficient to preserve long run equilibrium in each country's overall balance of payments. The internationalization of foreign exchange reserves would help provide this financing and give the International Monetary Fund the necessary leverage to promote such harmonization.

4. Convertibility cannot be meaningfully defined for policy purposes, except as a relative concept whose ultimate culmination would imply the total surrender of national sovereignty by member countries over all forms of trade and payments restrictions, and even over exchange rates. Such surrenders are utterly inconceivable today in favor of a mere nineteenth century *laissez faire*, unconcerned with national levels of employment and economic activity. The negotiation and implementation of negative convertibility commitments are inseparable from the parallel negotiation and implementation of positive integration commitments among the countries concerned. National policy instruments cannot be thrown away. They can only be traded against international, or supranational policy instruments adequate to serve the broad objectives of economic policy in the modern world.

5. The political, administrative, and psychological obstacles to full integration dictate a flexible approach to the problem of convertibility itself. Every opportunity for negotiable and workable agreements should be exploited as fully as possible, both on the world-wide level and on the regional levels. The potentialities of these latter forms of integration have been convincingly demonstrated by the success of OEEC cooperation since the war, by the

recent setting up of the European Economic Community, by the continuing endeavors to establish a European Free Trade Area or Economic Association, and by similar proposals for regional integration in other parts of the world (47). Closer regional agreements of this type can usefully supplement and support the looser agreements attainable on a world-wide level, and pave the way, under favorable conditions, to a complete merger of economic sovereignty among the participating countries. The last sections of this paper summarize the main features of the present European Monetary Agreement and suggest that it be strengthened and consolidated into a European Clearing Union or Reserve Fund, in order to provide a viable monetary and payments framework for the extensive trade commitments of a European Economic Association and of the European Economic Community. Such a Fund might, in the latter context, evolve gradually into a Federal Monetary Authority and provide the institutional machinery required for an eventual merger of the Six countries' national currencies.

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(47) The feasibility of such integration agreements outside Western Europe, and the adjustment of their aims and techniques to very different economic conditions, could not be discussed in this study. The reader may find a few introductory remarks to the problem in a paper of mine on "Latin America in World Trade and Payments" reproduced in the *Proceedings of the Fifth Meeting of Technicians of Central Banks of the American Continent*, Bogota (Colombia), 1957.