International Monetary System: 1973 Reforming in a Hurricane*

The effort to create a new set of principles for international monetary relations goes forward, with a deep sense of urgency, but with uncertainty as to what set of principles will best serve the future. The selection of a set of principles must be derived from historical experience and an evaluation of what future conditions are likely to prevail. The danger is to limit the analysis of historical experience to the last few years and to see the future in terms of months or, at most, a few years. Useful lessons can be learned from taking a longer time-horizon and the world to which the newly agreed principles are to apply should be seen in years and even decades. There is the danger that too short a time horizon will result in "reforms" adequate to meet current problems but not suited for future conditions. International monetary systems should be designed to endure. This requires flexibility and adaptability; it also requires a clear view as to what are the major current and emerging forces in the world economy.

Building the System: The Early Years

In the immediate years after World War II the principal preoccupation of countries was the reconstruction of the war-devastated areas. In international monetary relations United States policy during these years was greatly influenced by the conviction that the large increase in U.S. gold holdings which had resulted from

* The views expressed are not necessarily those of the World Bank, of which the author is a member of the staff.

the wartime conditions was inherently unhealthy. The United States held about 75 per cent of the world's total gold holdings. A decline in U.S. gold reserves was to be welcomed, even though much decline was not to be expected. This was the counterpart to the widely held view of a permanent United States dollar shortage: many economists argued that this dollar shortage would continue indefinitely and would require for many years, if not permanently, the use of exchange controls which discriminated against payments to the dollar area.

In this atmosphere of eagerness to help in reconstruction and unconcern with loss of gold holdings, the United States, in addition to its efforts to promote reconstruction, used its great influence to support efforts in various countries which strengthened their international competitive position. Thus, the United States supported the establishment of exchange rates by countries like Germany and Japan which were designed to encourage investment particularly in export-oriented industries and increase export earnings in the years ahead.

The United States also gave evidence of its intention to continue a liberal foreign trade policy. It gave leadership to the formation and activities of the General Agreement on Tariffs and Trade (GATT). In 1950 the European Payments Union was established with the strong support of the United States. It provided a regional payments and settlements mechanism instead of the bilateralism which was clogging intra-European trade and impeding European recovery. On a broader front the United States cooperated closely with European countries in the establishment of the Common Market.

During these years there was no question of the willingness of monetary authorities outside of the United States to increase both their official holdings of United States dollars and working balances in dollars of banking and other private institutions in their countries. Instead, as one country after another, especially in Western Europe, witnessed unexpected increases in their dollar holdings as well as gold, the reaction for many years was to keep redefining their needs for U.S. dollar holdings to ever higher levels. Very few had a crystal ball sufficiently clear to envisage the time when dollars would be available in too huge quantities and many countries abroad would actually take measures to prevent further acquisition and, finally, to deplete such holdings. Perhaps more attention should have been

paid to the attitude of Switzerland which had never been enthusiastic about increases in holdings of foreign national currencies, including the U.S. dollar.

The changing conditions of the 1950s enabled the International Monetary Fund to begin major operations. In 1951-52 the Fund had prepared itself for this major role by establishing new and more precise policies on use of its resources which were further evolved in subsequent years. These « credit tranche » policies, which represented radical departures from the literal reading of the provisions of the Fund Articles, linked the amount of resources used by a member to its performance in balance of payments management and other related domestic policies. Access to the Fund became only to a very limited extent automatic, but « stand-by arrangements », usually for one year, assured countries that as long as they followed policies set forth in these arrangements with the Fund, they would have access to the Fund up to specified amounts.

The Suez Crisis of December 1956 with the consequent sterling crisis was a landmark in the history of the Fund. A massive recourse to the Fund defended the pound from unwarranted devaluation. The precedent was established that major industrial countries would consult with the Fund on their domestic policies and balance of payments management when requiring assistance from the Fund. This willingness of countries to discuss their domestic policies affecting their balance of payments behavior was a major development of the 1950s. It was reflected not only in the work of the Fund but also in the work carried on by the OECD, particularly in its various working parties, in the deliberations of the Common Market and in the Bank for International Settlements. The 1950s saw the establishment of a system of monetary cooperation within which countries collaborated to create the conditions necessary for the fulfillment of the Bretton Woods principles.

Basic to these institutional developments in the 1950s was the widespread conviction and general confidence that the international adjustment mechanism could work successfully. Any inflation was regarded as temporary and manageable. Inflation did characterize many of the industrial countries during the 1950s, but the rates of inflation seemed low and hope remained alive that these pressures would be eliminated. Domestic stabilization policies were seen as the primary remedy for chronic balance of payments difficulties. Exchange rate changes by industrial countries were thought to be exceptional, but, in fact, proposed changes were not challenged and were even welcomed by the international community. Temporary deficits could be financed by use of reserves or drawings on the Fund or use of other short-term international credit facilities, if needed. The use of these facilities provided the time needed to adjust domestic policies without resorting to measures creating significant or sustained unemployment. From time to time exchange rates were adjusted through changes in par values in the Fund, when domestic policies by themselves could not overcome balance of payments weaknesses. It is simply wrong to regard the Bretton Woods system as one of rigid exchange rates.

Reflecting the growing improvement in the balance of payments positions of most of the industrial countries, exchange restrictions on payments were gradually withdrawn and foreign exchange markets were gradually restored to their previous importance in the early 1950s. More and more, money and capital markets rather than central banks and other governmental institutions became the main instruments for the conduct of international trade and finance. Thus, at the same time as the stage was being set for the general move to convertibility of European currencies, the stage was also being set in the 1950s for the strengthening of international banking and the formation of the Euro-dollar market which was to become so important in the 1960s.

Of key importance during this period was the willingness of the United States, despite a decline in its gold holdings, and an even larger increase in dollar liabilities, to extend support to countries in balance of payments difficulties, directly, and indirectly, for example, via the use of U.S. dollars held by the Fund. Thus, until the last years of the 1950s, the monetary system was functioning quite efficiently — whether measured by the avoidance of prolonged and severe recessions, the achievement of satisfactory domestic growth rates, the expansion of world trade and the steady diminution in reliance on exchange restrictions by the major industrial countries. The move to the general convertibility of European currencies towards the end of the decade dramatized the progress made. The one clear danger signal of future difficulties, was the persistence of inflation in many industrial countries including the United States, though at seemingly low rates of price rises.

Signs of Growing Uncertainty: The 1960s

Through most of the 1950s as in the late 1940s the overall U.S. balance of payments deficit was regarded as tolerable and even desirable. By 1958, however, the U.S. balance of payments deficit was no longer regarded with equanimity. The view became increasingly prevalent that the U.S. and other members of the monetary system desired to achieve the elimination of the deficit and the consequent increase in U.S. dollar balances held abroad.

By 1964 dollar balances held by monetary authorities abroad equalled the total gold holdings of the United States. It is essential to an understanding of the events of the 1960s, however, that it was generally believed in the United States as elsewhere that the U.S. balance of payments deficit not only could be brought to an end by general measures of demand management, but that it could be done without a change in the dollar price of gold and without ending the convertibility of dollars into gold at a fixed price.

Not much attention was given to fundamental changes in the exchange rate adjustment mechanism outside academic circles because of the basic assumption that the U.S. balance of payments deficit was temporary and reversible. No change in the existing link between gold and the U.S. dollar was seen as necessary. Discussion even began in earnest in the early 1960s on how to increase world liquidity because of the prospect of the elimination of the U.S. dollar deficit as a major source of additional liquidity. Concern was now expressed that given the new levels of output, employment and foreign trade, world liquidity would prove to be insufficient.

It is impossible to say whether the confidence felt in the first part of the 1960s that the U.S. could in a relatively short period of time bring its balance of payments into sustained equilibrium or close to equilibrium was justified. It may have been possible if the problem had been seen as the need to eliminate the continuing inflation, which, *inter alia,* was eroding the international competitiveness of American industry. The acceleration of the war in Viet-Nam meant, however, the strengthening of inflationary pressures in the United States as fiscal policies were not taken to cope with the heightened levels of demand. The adjustment mechanism was greatly hindered, if not disrupted.

The increase in the rate of U.S. inflation in the latter part of the 1960s steadily strengthened growing inflationary expectations. Increasingly, new pessimistic interpretations, derogatory to the United States economy, were now given to the continued balance of payments deficits. Views were expressed, particularly in academic circles, that the U.S. would need to move to a floating exchange rate system.

All of these developments reinforced each other. To the monetary authorities outside the U.S. who held dollars, the risk inherent in their so doing became increasingly apparent, particularly in the market pressures on the gold price. Central banks were reluctant to use substantial portions of their gold reserves to keep down the gold price in the open market. Trying to prevent the losses of monetary gold to non-monetary users by constructing a closed system for monetary gold, the two-tier market for gold was established in 1968. This permitted the price in private markets to be determined by the forces of supply and demand without official intervention, while the official price remained unchanged. It strengthened the likelihood that central banks would even more assiduously hoard their gold holdings and that balance of payments deficits would be met by the use of dollar holdings rather than gold. It thus reinforced Gresham's Law as applied to monetary reserves.

During this period of ever mounting international liquidity created by the U.S. balance of payments deficit, discussions went on with respect to future sources of international liquidity. Although the cessation of large increases in the world's monetary reserves in the mid-1960s proved temporary, the stage was still being set for the introduction of a scheme to supplement existing sources of international liquidity. Such a scheme, the Special Drawing Rights (SDRs) in the Fund, was introduced in 1970. By then Special Drawing Rights were, however, seen both as a mechanism to replace the world's reliance on U.S. dollar deficits for increases in liquidity and to help bring about the sustained elimination of this deficit.

The transformation of the Euro-dollar or Euro-currency market into a major element in the international monetary system was a notable by-product of the marked increase in international liquidity in the 1960s. The supply of foreign exchange, mostly dollars, resulted from economic activities in all parts of the world. Oil revenues from the Middle East, capital flight from Latin America, European central banks eager to find some use for their mounting dollar balances, branches of U.S. firms wishing to escape the limitations on direct foreign investments placed on their home companies, and

American banks eager to profit from the lively business in Europe and elsewhere, provided dollar deposits and deposits in other currencies which grew rapidly by the billions of U.S. dollars. It became possible for firms in the United States and elsewhere to look to London and other European centers to provide in important amounts financing not only for international transactions, but also to meet domestic financial needs arising out of domestic credit policies or institutional limitations. Banking and other financial institutions were developing the international sophistication and machinery to deal with their counterparts in the industrial world.

With these developments in the 1960s the management of international capital movements as well as domestic monetary conditions became more difficult. Both inflows and outflows of funds were increasingly sensitive to changes in credit conditions as well as to anticipations of exchange rate changes. International finance had become more efficient and, in so doing, paradoxically the vulnerability of the international monetary system to disequilibrating capital flows had been greatly increased.

Crisis in 1970/71: The Collapse of a System

By 1970 it was clear that domestic demand management in the United States as practiced, was not ending the balance of payments deficit. At the same time, the enduring deficit meant further large increases in U.S. dollar holdings abroad and a keen widespread awareness that United States could not in practice fulfill its legal commitment to convert dollars into gold at $35 per ounce. The U.S. simply did not have enough gold to lose to enable countries to convert their dollar assets into gold, while conditions in the United States did not induce sufficient investments from abroad of these dollars in the United States itself. The result was that these dollars remained abroad in official and private holdings, increasingly sensitive to fears of purchasing power decline resulting from inflation or changes in exchange rates. The adjustment mechanism was not working; the situation had become explosive.

The explosion came at the beginning of the 1970s though the sparks were visible in 1969. The fuel for the explosion was being increasingly generated by the persistent world inflation. The world economy ended the decade of the 1960s and opened the 1970s under

mounting inflationary pressures. In a setting of high demand, substantial price increases, and strong reliance on monetary policy in the main industrial countries, interest rates soared even beyond the high levels which had become customary in the postwar period. Under these circumstances wide differences in interest rates among industrial countries could be expected with resultant large-scale movement of funds internationally.

During the first nine months of 1969 recurrent speculative storms swept across the foreign exchanges. Apprehension was widespread that acute disequilibrium in the relatively weak French and strong German payments positions would trigger a world financial crisis. The French franc was devalued in August, 1969 and the German mark revalued in October. Temporary relief to the strains on the international monetary system was obtained, but the euphoria which prevailed at the end of 1969 and very early in 1970 lasted for only a few months.

In 1970 there was a heavy outflow of short-term funds from the United States in response to interest rate differentials; the U.S. had eased its monetary restraints while German banks and industrial firms sought relief from stringent credit conditions by borrowing from the Euro-dollar market. The United Kingdom and France had similar experiences. As capital flows from the United States resumed in 1971, they were augmented by speculators' funds; they had become increasingly convinced that European exchange rates would again be revalued. Monetary measures taken in Germany to discourage the inflows proved inadequate. The situation came to a head in the first two working days in May, 1971 when a further $2 billion inflow into Germany forced its authorities to close the exchange market.

Germany and the Netherlands floated their currencies. Austria and Switzerland revalued. There were now three major industrial countries — Canada, Germany and the Netherlands — that were not maintaining parities in accordance with the provisions of the Fund Articles of Agreement.

Exchange markets remained nervous. The conviction grew that an upset in the relations between the dollar and virtually all other major currencies might well be near. This conviction was strengthened by a U.S. Congressional sub-committee's report early in August, 1971 calling for a general realignment of exchange rates against the dollar. It added that otherwise the United States might

have no choice but to take unilateral action to suspend the convertibility of the dollar. In an already nervous market, the effect was instantaneous. During the week that followed, another $3.7 billion in U.S. dollars was added to the reserves of other countries. President Nixon reacted to this general pressure on the dollar by the historic step taken on August 15, 1971 of suspending the convertibility of the dollar into gold. By his action President Nixon brought to an end what might be called the post-World War II era in international monetary relations. He opened a transitional period to a new era.

This transition period is still going on and may go on for years. At first, as will be seen, the reaction of the international community was to preserve much of the old, in word and substance. As time went on, more and more of the substance was changed, while much of the old words remained. The result is obscurity and confusion between actuality and legal forms. Until a new system is evolved, the actuality in exchange markets will be of prime importance. But only when behavior in exchange markets conform to internationally agreed rules, can there be confidence in the durability of the system.

Smithsonian Experience

After August, 1971 exchange rates for major currencies were determined in exchange markets by the interplay of supply and demand and monetary authorities exercised their own judgments as to the appropriate intervention policies. In December, 1971 a meeting of the Group of Ten countries was held in the Smithsonian Institution in Washington which was intended to bring to an end this uncertainty in exchange markets and to pave the way for thoughtful and careful reform of the existing monetary system.

The Ministers and Governors, according to the communiqué which those attending issued, agreed to what was described as "an interrelated set of measures designed to restore stability to international monetary arrangements and to provide for expanding international trade". The hope was expressed that all governments would cooperate through the Fund to permit the implementation of these measures "in an orderly fashion". Agreement was reached on the pattern of exchange rate relationships among the currencies of the Ten, now in the form of par values or central rates as countries desired. The United States agreed to propose to Congress a suitable means for devaluing the dollar in terms of gold from $35 to $38 per ounce.

Significant for the longer run was the agreement that discussions should be promptly undertaken, particularly in the framework of the Fund, to consider reform of the international monetary system over the longer term. In effect the agenda for these discussions was set forth in the Smithsonian communiqué: "it was agreed that attention should be directed to the appropriate monetary means and division of responsibilities for defending stable exchange rates and for insuring a proper degree of convertibility of the system; to the proper role of gold, of reserve currencies, and of Special Drawing Rights in the operation of the system; to the appropriate volume of liquidity; to re-examination of the permissible margins of fluctuation around established exchange rates and other means of establishing a suitable degree of flexibility; and to other measures dealing with movements of liquid capital. It is recognized that decisions in each of these areas are closely linked".

After this meeting the International Monetary Fund announced that it had adopted a decision establishing a temporary regime under which a member could permit the exchange rate for its currency to move within margins of 2¼ per cent on either side of the par value or the new exchange rate value of its currency (called "central rate") resulting from the agreed realignment of exchange rates.

The changes made at this time represented major departures from the international monetary system: the established legal link between dollars and gold had been broken; countries changed their exchange rates without changing their par values; wider margins were in practice permitting small changes in exchange rates without specific international approval; the mechanism for future changes in exchange rates was now unclear. What had remained from the existing monetary system was that countries did not re-introduce restrictions on current payments and the concept of close collaboration by countries to avoid disorder in exchange markets continued to have meaningful content. A general floating exchange rate system for the major countries with the continuing exception of Canada, was, at least temporarily, avoided, thus reconfirming the principle of exchange rate stability, though now importantly modified by the use of wider margins and otherwise.

The U.S. action, the Smithsonian agreement and its aftermath in the Fund had importantly altered the international monetary system. The viability of the mechanism was soon, however, seriously in doubt. The mechanism could be rather easily upset and was.

The Lessons of the Crises of 1969-71

Repeated crises of 1969-71 which climaxed a decade of growing uncertainty left a legacy of a widespread conviction that the international monetary system needed to be thoroughly reconsidered and probably restructured. The dollar was still the major reserve currency, even though its convertibility into preferred monetary reserves especially gold and SDRs was severely limited. Moreover, the volume of dollars held abroad by monetary authorities was huge and mounting, soon to reach over $100 billion, despite the strong reluctance by the monetary authorities of most industrial countries to acquire more U.S. dollar reserves. The primary lesson seemed clear. A reserve system needed to be evolved based on the general acceptability of the reserve asset(s).

The events of 1969-71 drove home certain other lessons. Any international monetary system had to be based on a pattern of exchange rates which was both realistic by objective economic criteria — behavior of the balance of payments and absence of restrictions on current payments — and, equally important, also was subjectively widely regarded as realistic. Moreover, this rule had to apply also to currencies which performed a reserve asset function. Closely linked was the realization that postponement in needed exchange rate adjustment made the adjustment mechanism much more difficult to operate efficiently.

The Smithsonian negotiations and agreement drove home yet another lesson: The equilibrating mechanism could not be conceived only as, in effect, changes in exchange rates between the U.S. dollar and other currencies. Instead, it was the world pattern or structure of exchange rates, particularly of the major industrial countries, that has to be kept under review and adjusted according to changing conditions. This was evidenced by the differentials in changes in exchange rates among the major industrial countries. This problem might become simplified as the Common Market countries made future progress in monetary collaboration but this was still to happen. The multilateral character of exchange rate adjustment required efficient machinery for international consultation among countries. Much would depend on how far the nations of the world were ready to compromise national sovereignty in this field.

The events of 1971 also demonstrated that any efficient monetary system had to be prepared to deal with very large swings in the balance of payments, frequently of an unpredictable character. Many countries were not prepared to permit their exchange rates to be determined in free markets without official intervention or some form of controls. A high degree of certainty or stability in exchange rates was still valued from the viewpoint of the orderly and efficient conduct of international trade and finance. As long as this principle was guiding, large balance of payments deficits and surpluses were to be expected. The system had to be protected from disruption, particularly when upsetting movements of funds took place. Temporary deficits, resulting from such movements could otherwise force unwanted and unwarranted changes in exchange rates or the introduction of exchange and trade restrictions. This pointed to the need for some kind of quickly operating and virtually automatic mechanism such as techniques for recycling to handle abnormal capital flows or use of capital controls or other forms of restraint.

Another lesson of 1971 was the difficulty of carrying on negotiations for reform during peace time. The Bretton Woods discussions, and the years of discussions among countries which preceded Bretton Woods, were carried on during World War II. Deliberations were thus divorced from the day to day international economic and financial relations. Exchange controls and government procurement and deliveries determined international trade; the international dimension of war finance was principally Lend-Lease and Reverse Lend-Lease. Now, negotiations on monetary reform are being conducted in peace time amid high levels of international trade and capital movements. No one wants to disrupt this trade and finance. Nonetheless, there were and are bound to be disturbing interactions. In consequence the detailed reform this time may well take place on a piecemeal basis, after there has been some agreement on general principles, objectives and mechanisms. There is a dilemma caused by the desire for speed because of dissatisfaction with the uncertainties created by a trans-

itional mechanism and the need for a reform which is realistic and durable. In the realm of international relations and negotiations it is not possible to predict the pace which will be found practical.

After Smithsonian: Reforming in a Hurricane

1972

The Smithsonian agreement and the consequent exchange rate arrangements did prove fragile and temporary. The Smithsonian had not dealt with the underlying causes of uncertainty, e. g., the widespread doubts about the willingness of major countries to defend the new pattern of rates even if it involved large additional accumulations of dollars; persistent inflation; the huge accumulation of U.S. dollar balance abroad; the inadequate inducements to bring about a reflow of funds to the United States; the possibility of new massive disequilibrating capital movements, etc. Smithsonian, therefore, succumbed after a year to a hurricane whipped up by the winds of speculation loosened by even stronger expectations of changes in exchange rates and capital movements.

A system which failed to generate confidence was undermined by persistent inflation, which made mince-meat of the Smithsonian pattern of exchange rates. The strengthened world international financial and industrial structures provided the mechanism for companies to protect their assets or increase their earnings by moving funds internationally. Their collective actions, being massive and virtually simultaneous, could and did overwhelm intergovernmental arrangements and understandings. The conscientious company treasurer, learning that the U.S. dollar could be devalued, had to assume that it could happen again. To operate otherwise, he had to be convinced that, although devaluation was a theoretical possibility, it would not in fact happen in the foreseeable future. If there was any ground for believing that the values of major currencies might be altered, or existing freedom on movement of funds would be inhibited by future governement restraints, speeches by important leaders (private and official), budgetary statements, new balance of payments statistics or forecasts, rumors of proposals in reform discussions, talk of capital controls, and so forth, could trigger disequilibrating capital movements.

During the first part of 1972, exchange markets, however, reflected a reasonable calm about the monetary system. In June, 1972, the United Kingdom, confronted by continued strong domestic inflationary pressures, decided to float the pound sterling. Although this was a major rupture in the exchange rate pattern and generated large flows of speculative funds, it was not read as a sign of the need for a change in the U.S. dollar or other major European currencies or the Japanese yen. Other EEC currencies followed the pound down for a very brief period, but by mid-July the general pre-June 1972 picture was quickly re-established. The continental European central banks demonstrated their determination to defend their exchange rates. The pound continued to slide downward; by the latter part of October, however, it began to strengthen and the decline stopped. For the remainder of the year 1972, the modified Smithsonian exchange rate pattern seemed viable.

Against this promising background, it was not surprising that the prospects for agreement on international monetary reform heightened considerably at the annual meeting of the Board of Governors of the IMF in September, 1972. In June, 1972 the so-called Committee of 20 had been formed. In the September meeting in Washington of the Governors of the IMF, the U.S. Secretary of the Treasury, Mr. George Shultz, and the French Minister of Finance, M. Giscard d'Estaing, took conciliatory positions giving priority to improvements in the adjustment process and the role of exchange rates in this process.

It was widely agreed that there was need to reform the settlement and reserve system in which the primary role should be assumed by a SDR-type of asset, while the role of national reserve currencies — the U.S. dollar being by far the most important — should be gradually confined to the level of working balances needed by central banks for their interventions in exchange markets. Convertibility should be defined in terms of SDRs, rather than gold, and the restoration of dollar (and sterling) convertibility would require the substitution of some modified SDRs for the very large outstanding reserve currency holdings inherited from the past and in excess of necessary working balances. Finally, considerable stress was placed by a number of Governors on the need for a revision of the system of SDR allocations, and particularly on

the possibility of establishing a "link" between SDR creation and development aid.[1]

This promising climate created at the September meeting set the stage for the first meeting of the Deputies of the Committee of 20, on November 28-29, 1972 in Washington, chaired by Mr. Jeremy Morse of the United Kingdom. A U.S. memorandum on the adjustement process started the serious technical negotiations of a monetary reform.

1973

Yet within a little more than two months the climate had completely changed; the technicians could not, of course, take the political decisions needed to solve the underlying conditions which continued to threaten international monetary relations. On January 21, 1973, the United States announced its first trade deficit with Western Europe in 30 years and the largest trade deficit in its history. On January 22, the Italian authorities introduced a two-tier market for the lira and the next day Switzerland decided to float its currency. The Swiss franc rose sharply which cast doubt on the Smithsonian pattern of exchange rates. Speculative pressures in exchange markets increased, particularly in Germany. Then the new U.S. budgetary proposals revealed expectations of a continued large budgetary deficit, while the U.S. moved away from its so-called Phase II with its reliance on wage and price controls to limit its inflation to the essentially voluntary anti-inflationary program of Phase III.

At first the German Bundesbank intervened to defend the German mark exchange rate, but the early days of February, 1973 saw huge speculative movements into European currencies, particularly the German mark, and into the Japanese yen. It was public knowledge that the European central banks were again adding billions of dollars to their already reluctantly held large dollar reserves. It was also common knowledge that a key point in the monetary reform discussions had been how to decrease these dollar holdings. Once more alert corporate treasurers could not afford not to incur the relatively small expense of moving into European currencies and the yen to the extent permitted.

[1] For a useful concise analysis of the main issues in the international monetary reform, as seen before the events of early 1973, see "Prospects for International Monetary Reform" by Robert Triffin, *The Banker*, February 1973.

During the second week of February, the market atmosphere continued to deteriorate. By Friday, February 9, the Bundesbank had absorbed nearly $6 billion. On February 12, the U.S. Secretary of the Treasury announced that the dollar would be devalued again by 10 per cent with the understanding that, in addition to those countries already floating, the yen would be allowed to float.

"During the international discussions, it became clear that there was widespread agreement that the exchange rate realignment should be fully adequate to accomplish the common objective of placing international payments firmly on the road to equilibrium".[2] In support of this agreement, the industrial nations permitted their currencies to reflect the full devaluation of the dollar. With rumors of a joint EEC float in the event of renewed massive capital inflows, coupled with the fact that the Swiss franc was appreciating significantly more than other European currencies, the exchange market remained skeptical as to whether the crisis was indeed over. By Friday, February 23, the dollar had fallen to its new floor against the mark, French franc, guilder, and Belgian franc. Although the beginning of the week of February 26 saw a brief improvement, by Thursday, March 1, there was an unprecedented rush into continental currencies — European banks purchased more than $3.6 billion to maintain the exchange rate limits. That night European and Japanese officials announced that the market would close until further notice and that arrangements were being made for an emergency meeting to be held that weekend. (The markets were closed March 5 - 9 in Europe and Japan with the dollar generally quoted below its new floor in light trading). The speculators had again proven themselves prudent businessmen.

During a weekend meeting of March 9, the EEC countries decided on a joint float for most of their currencies, i.e., to remain pegged to each other, but not in relation to non-EEC currencies, particularly the U.S. dollar. Britain and Italy were to float independently. Switzerland and Japan continued to float independently.

Many authoritative communiqués were issued in March as repeated meetings were held of the Ministers and Central Bank

[2] Federal Reserve Bank of New York, *Monthly Review*, March 1973, C. A. Coombs, "Treasury and Federal Reserve Foreign Exchange Operations", p. 49.

Governors of the countries concerned. The Committee of 20 in its communiqué of March 27 summarized its views on exchange rates as follows: "Members of the Committee recognized that exchange rates must be a matter for international concern and consultation and that in the reformed system the exchange rate regime should be based on stable but adjustable par values. It was also recognized that floating rates could provide a useful technique in particular situations. There was also general agreement on the need for exchange market stability and the importance of Fund surveillance of exchange rate policies". Thus, the basic approach or philosophy of the Smithsonian agreement could be regarded as preserved or re-affirmed. But in practice, the international monetary system was no longer on a stable rate basis. The existing system was now essentially on a floating basis. Most major central banks have ceased to intervene in the foreign exchange markets leaving the U.S. dollar rate to rise or fall.[3] Japan has been a notable exception to avoid even more revaluation of the yen.

1973 is reflecting the vulnerability of the monetary system as long as the fundamental causes of exchange rate instability exist, particularly doubts about the viability of the existing pattern of exchange rates and about the willingness of monetary authorities to defend this pattern irrespective of their attitudes on holding national reserve currencies and on extending or accepting short-term international credit for this purpose. Despite the major further devaluation of the U.S. dollar in the Winter of 1973, further declines in the foreign exchange value of the dollar were experienced later in the Spring and Summer of 1973. In August, 1973, there were signs that the continuing deterioration had, at least temporarily been halted and the dollar strengthened in the subsequent autumn months.

Comments on the Future

Again time had been bought for carrying forward the discussions on international monetary reform, but key underlying disruptive factors remain. No one knows how much time has been bought

[3] This does not exclude the possibility of active intervention to maintain orderly market conditions.

because it is not a calculable figure. It could be weeks, months or even a few years. As long as inflation persists, the shorter will be the breathing space. If persistent inflation is eliminated, this will make possible finding a durable exchange rate pattern. The thorny questions now involved in the adjustment process issue would then become more manageable and the need for changes in rates would be more infrequent, irrespective of the rules adopted for changing exchange rates.

Those responsible for bringing about the new international monetary system are still bedeviled by the fact that the old international monetary system was disrupted before a new system had been devised to take its place. The reform of the system is also proving difficult because it is taking place during a period when the international economic system is in full operation. The exchange markets can, at most, be suspended for only very short periods. The mechanisms by which disturbances and concerns are transformed into large upsetting international transfers of funds are essentially the same mechanisms which also finance the world economy and particularly the highly desired flow of world trade and capital.

The proper pattern of exchange rates is hard to judge. The assumption is easily made that the pattern was "correct" at some time in the past and changes in relative economic and monetary conditions cause them to become out of line. In fact, the pattern of exchange rates established after World War II was inevitably arbitrary and there had not been a long enough period of more normal international behavior to establish a new working base: war had destroyed the bases for careful calculations. The pattern agreed after the War reflected political willingness to encourage the reconstruction of Western European countries and Japan.

It may be that the convulsions of 1971 and 1973 in the exchange rate field will turn out to be largely the final steps in the process of finding appropriate exchange rate relations among the major industrial countries. The widespread prevalence of persistent inflation obscures the situation and cautions against optimistic conclusions. The answer as to the validity of the present exchange pattern will be found in the months and years ahead not only in the balance of payments behavior of these countries but also in their ability to achieve critical top-priority domestic objectives.

The present mixed system combining floating of the major

currencies — some floating in relation to all currencies, some in relation to the dollar but pegged to each other — and fixed rates may avoid large further increases in national reserve currencies. Much will depend on the efficacy of the capital restraining measures and the willingness of countries to tolerate further significant changes in exchange rates. The pattern of rates of the major currencies will have to be relatively stable for many months, if not years, before it can be regarded as "realistic" and "viable". Until then domestic or international events can generate uncertainties about the future foreign exchange values of currencies. Much will again depend on the effectiveness of domestic economic programs, particularly in achieving the elimination of inflation while maintaining acceptable levels of employment and income. As long as inflation continues, exchange rate changes may well not result in the balance of payments changes which might otherwise be reasonably expected. The present mixed system may be a harbinger of a more generalized system of floating or of a return to a more fixed pattern. It is too early to predict.

It may be expected that progress will be made in agreeing on a set of principles to govern international monetary relations in the future. This progress, however, may well be slow . A number of difficult issues remain to be resolved within and among countries. For example, within countries, what priority will be given to ending persistent inflation and will governments be prepared to adopt anti-inflationary policies compatible with other domestic objectives like avoidance of significant unemployment? What importance will be attached to high levels of exports to achieve domestic aims of low levels of unemployment and relatively high levels of growth? How much international competition will be welcome or tolerated, particularly from the United States? Should the U.S. limit significantly export of long-term capital to other industrialized societies? What, then, should be the rules on technology transfers? Should the United States no longer be allowed to finance its external deficits by use of U.S. dollars which can be held by monetary authorities in U.S. Treasury bills? (This is, in effect, borrowing from these countries at short-term rates). Are guarantees against further losses from exchange rate changes necessary or feasible? Or, should the U.S. be forced to pay higher rates of interest on these loans abroad via various possible changes in rules on reserves and settlements? Would the U.S. respond to the new forms of deficit financing by reducing borrowing significantly or would the persistent inflation, as long as it existed, result in a change in the form of external borrowing, but not affect significantly the magnitudes? If the U.S. continued to borrow abroad at short-term, now, or long-term later, would other countries be eager to see other changes in the U.S. balance of payments, particularly the export and import accounts, which would offset these debit items — already in the magnitudes of $5 billion per year or more? And so forth.

I believe that mutually acceptable answers will be found because countries cannot handle their domestic economies without knowing what international rules are likely to prevail; these cut across wage, monetary, fiscal, investment, foreign trade, research and development, social, environment and other policies. Governments tend to emphasize short-run interests; monetary and other non-political authorities are more likely to take a long-run view. But, however defined, and however slowly, national positions will be compromised eventually to find a set of internationally agreed rules and to provide for an international mechanism to help implement these rules.

It is very tempting during a period of intensive reform discussions and negotiations to slip into unrealistic doctrinaire rigid positions on the details of a system. The basic ingredients of a system are an agreement to collaborate in maintaining a viable international monetary system, an agreement on some set of rules which are commonly accepted, and an agreement to conform domestic behavior to these rules, and, when not possible, to seek international permission for non-conforming. The set of rules needs to be internally consistent: — the rule on monetary reserves and settlements, for example, should not make nonsense of the rules on exchange rate adjustment. But more than one set of principles is possible: numerous sets of principles can be enunciated and countries have greatly changed their positions during the last two decades on what set of principles they preferred. Even within a single country it is difficult to be certain as to which set of principles serves "national" interests since these are not necessarily homogeneous.

In any case, the set of principles finally agreed must be mutually acceptable and, therefore, compromise existing individual national definitions of what is best and desirable.

Grave difficulties would come from failure to collaborate in

finding an acceptable compromise and failure to abide by any set of rules — not from agreeing on a compromise of a mutually acceptable set of principles. Perhaps the only safe prediction is that the durability of any precise set of rules as originally agreed will prove to be relatively short-lived, and that innovative management of the system based on recognition of the need for flexible implementation of the rules based on the call for mutual accommodation will prove more important than the original set of rules.

In the meantime, a tentative accord may be reached on how to conduct relations during the interim period before general reform is agreed upon. If an interim arrangement proves viable it might lessen the sense of urgency to agree on the longer-run principles and give more time for deliberation.

There are three essential elements of a workable transitional arrangement: clear agreement on the degree of mutual tolerance and support for the existing exchange rate pattern and mechanisms, the avoidance of a return to restrictions on current payments by the industrial nations and some form of collaboration on disequilibrating capital movements.

The first element is most important. With respect to exchange rates, two alternative courses of action suggest themselves. In essence, if the major countries can concur that, on the one hand they will be willing to accumulate and hold more national reserve currencies, namely U.S. dollars, until an alternative system is devised, some satisfactory temporary arrangement would seem possible based essentially on the existing exchange rate pattern. This would mean that the countries concerned would agree that the accumulation of more dollars is less objectionable than permitting further major changes in the pattern of exchange rates. Creation of more certainty in the exchange markets would be given top priority. Such a decision could be signaled by a clear declaration of the countries to this effect. If this were done, it might well reduce the amount of U.S. dollars otherwise accumulated abroad since it could end speculative capital movements based on expectations of further U.S. dollar devaluations. To achieve this, the signal to defend the existing pattern of exchange rates would have to be unqualified and unequivocal.

If this were not feasible, the continuation of the present mixed system may well be a more satisfactory temporary solution than an inadequate defense of the existing pattern. It would involve at most a limited commitment to acquire more national reserve currencies, but would also mean a willingness to permit the major exchange rates to adjust to changing market conditions. This could also mean changing the present fixed relations among certain countries, particularly the pegging among certain EEC countries. Again, much would depend on the willingness of countries whose exchange rates are pegged to each other to accumulate more national currency reserves or to alter the composition of reserves or to harmonize domestic economic policies in order to effectively defend the fixed relationships.

Finally, to look at the problem from a long-range viewpoint. In a world of population explosion, rising expectations and their realization and critical resource scarcities, national efforts to achieve domestic and external monetary goals can not succeed unless they are part of an international effort which recognizes the deep roots of modern monetary instability in a highly inter-dependent world.

The difficulty in progressing rapidly to an agreement on a new set of principles offers an opportunity to re-examine the purposes of the system. In addition to the purposes already enunciated here and elsewhere, I believe that re-examination should encompass major new responsibilities for the international monetary system; first, to evolve a program on a country-by-country basis to eliminate persistent inflation. This would be comparable to the responsibilities given in earlier years to the IMF for the elimination of restrictions on current payments. And, second, to provide an international monetary structure which would facilitate the on-going structural transformation of the world.

Structural transformation has a vast scope. It includes not only the social and economic development of the low income countries but also the world environment — the rebuilding of urban centers in the developed and developing countries, the modernization of infrastructures and other facilities to handle the huge increases in population, the exploitation of oceans and sea-beds, ending the threat of food shortages, etc. Private institutions like the multinational corporations and the Euro-currency market already reflect this transformation. The underlying problems and the conditions that accompany this transformation will dominate the international behavior of governments and countries for decades. Any successful efforts to eliminate persistent inflation will be an integral part of the orderly process of transformation and these

efforts will not succeed on the national level unless they fit into this global process.

The international monetary system could assist in many ways: technical assistance, where appropriate; in national and international institution building; in defining proper creditor and debtor behavior in the adjustment process in such ways as to give due account to the possible balance of payments consequences of these structural changes; in helping to provide support for countries experiencing balance of payments difficulties because of their cooperating in agreed international programs; in helping countries to pursue such programs in a manner which obtains the fullest possible benefits of expanding international trade and productive flows of capital and technology; in calculating and providing for international liquidity; in the formation and usage of international reserve media, etc.

There are, doubtless, innumerable practical difficulties in defining and agreeing on a specific role for the international monetary system which would support the structural transformation of the world. There is not yet international understanding or consensus on the content, sequence or pace of this transformation and the extent to which governments can and should affect them. It is, however, more important to establish the principle of having this responsibility than to detail its implementation. This can be left to future policies and procedures of the agreed international authority (presumably the IMF) in consultation or collaboration with other concerned international agencies. If this responsibility or purpose is not accepted for inclusion in the new set of principles, there is the danger that the international monetary system will become anachronistic before the decade of the 1970s is over.

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