

## Amending the Fund's Charter; Reform or Patchwork?

### Introduction

The final agreement reached at the Jamaica conference earlier this year has put, at least temporarily, an end to a long negotiating process which, in a sense, had started twelve years earlier. The agreements reached have been set out in the *communiqués* issued at Jamaica and before,<sup>1</sup> and are for the most part embodied in an amendment to the Articles of Agreement of the International Monetary Fund (IMF). The ratification process of this amendment is now getting under way in the various member countries of the Fund. This is therefore an appropriate time to sit back to analyze and evaluate the package of agreements reached at Jamaica, and especially their significance for international monetary relations during the next few years. It is the purpose of the present article to do this. In the process, the main points of the agreements reached will be briefly described. The opinions expressed are purely personal.

The term "international monetary relations" used above describes the present situation better than "international monetary system", because in my opinion at the moment no agreed comprehensive system of coherent rules exists any longer. Fundamentally, this is the result of the fact that the major changes in international financial relations over the past few years have come about through the *breakdown* of the old system and not as a result of its conscious *reform*. This occurred when the authorities, forced by circumstances, ceased to observe particular rules without wanting to bring about the results that flowed from their action. The advent of flexible

exchange rates in 1973 is a telling case in point. In the face of overwhelming pressures from speculators, it became impossible for the authorities to maintain support of their exchange rates under the existing rules for intervention. Such intervention at times involved the purchase of currencies by the authorities to the tune of several billions of dollars within a single day, sometimes within a single hour. They were thus forced to cease their intervention. Floating exchange rates were the unwanted result.

### Early Warnings of Impending Trouble

The fact that fundamental changes in international monetary arrangements have come about through breakdown rather than through reform is disturbing. One unsatisfactory result is that no agreed conception exists on how the new system is to be operated, for instance on the criteria by which to judge the exchange rate policies of a country which has adopted managed floating. Another, more general, disturbing feature is that we observe similar trends in other fields, for example in the decline in real terms of official funds available for development assistance, and the slow movement toward European economic integration. There is thus for the moment a general low tide in international cooperation, whose fundamental causes are inadequately understood.

The developments in international financial relations are the more striking since the tensions that had been emerging in the system and the causes of its instability had been fully analyzed. Moreover, a large measure of agreement on necessary remedial action had been achieved both in the academic community and in official circles.

In the academic field the first warning, together with a detailed remedy, came as early as 1959 in the form of two articles in the March and June issue of this Review by Robert Triffin, republished the following year as his now famous book *Gold and the Dollar Crisis*. In the ensuing discussion, the academic community reached a large degree of consensus around 1964 on what should be done, when on the initiative of Fritz Machlup 32 economists produced a report entitled *International Monetary Arrangements: The Problem of Choice*, published by the International Finance Section of Princeton University. And after the Smithsonian agreement of December 1971

<sup>1</sup> The *communiqués* in question of the Ministerial "Interim Committee" have been reprinted in the Annual Report 1976 of the Executive Directors of the Fund, pp. 119-24.

had temporarily patched up the par value system, a large measure of agreement on remedial action was reached in official circles in the summer of 1972. This was contained in a report by the Executive Directors of the International Monetary Fund — based on an imaginative first draft from its Economic Counsellor, J. J. Polak — entitled *Reform of the International Monetary System*.

### The Shortcomings of the System

What then were the shortcomings of the system? First, the process designed to maintain international payments equilibrium — the adjustment process — was found to function less and less effectively. For the most part this was due to a tendency toward increased rigidity of exchange rates under the Bretton Woods par value system, a rigidity that went far beyond what had originally been envisaged. “In future, the external value of sterling shall conform to its internal value as set by our own domestic policies, and not the other way round”, Lord Keynes, one of the Founding Fathers of the Fund, had emphasized in a speech in the House of Lords on May 23, 1944. In fact, over time, the system evolved in a very different direction. This was mainly the result of the fact that adjustable par values and free international capital movements are incompatible, since the combination leads to unmanageable currency speculation. Yet capital movements were freed. The result was rigid exchange rates and hence the disappearance of an adequate adjustment mechanism for international payments.

Second, in the Bretton Woods system proper there was no practical provision for an increase of international liquidity. However, given the central position of the dollar, many countries found it convenient to add easily usable, interest-earning dollar balances to their monetary reserves instead of gold. This made additions to international liquidity possible, but dependent on the U.S. balance of payments position, and on the decisions of individual countries to hold on to their dollars rather than to convert them into gold. Both these elements were completely unrelated to the need of the world economy for liquidity, and moreover were beyond any general control. In addition, the volume of international liquidity was influenced by changes in the monetary gold stock. These changes were dependent on the caprice of gold production and Soviet gold

sales on the one hand, and private demand for gold on the other, factors equally unrelated to the need for liquidity and equally outside rational monetary control. Thus international control over international liquidity was lacking.

The third problem, related to the second, was the absence of an internationally managed reserve asset. This not only hampered international control over international liquidity, but it also implied that the savings involved in the accumulation of monetary reserves flowed to the world's richest country, the United States, which provided the new official liquidity in the form of dollar deposits with American Banks. These reserve-arrangements, called the gold-exchange or gold-dollar standard, were moreover prone to a well-known instability as a consequence of the continued accumulation of short-term debt by the reserve center. This led to the downfall of the pound in 1931 and to that of the dollar in 1971, exactly 40 years later.

### Action Taken

The international community responded by solving the easiest of the three problems which had arisen, namely the need for an international reserve asset, by the creation of more paper money. Agreement was reached in 1968 on arrangements which permitted the creation in the Fund of an international reserve asset called special drawing rights, SDR for short.

However, on the two other points the international community adamantly refused to take any meaningful remedial action. The two pillars on which a reformed international monetary system was to be constructed were “fixed exchange rates and the established price of gold”, as the Ministers of the Group of Ten put it in 1964 and repeated over the next few years. Yet it is precisely on these two points, and on these two points only, that the Jamaica agreement contains fundamental changes as far as the *system* is concerned. The fact that the agreement mainly recognizes and legalizes the changes that had already evolved spontaneously does not alter this fundamental truth.

It is a rather puzzling fact that the Committee of Twenty, charged to produce an Outline for a comprehensive reform of the system by the Governors of the Fund, never discussed the fundamentals of the exchange rate system, even though the par value system

broke down during the course of its deliberations and the world moved from fixed to flexible exchange rates under its very eyes. In fact, three weeks after the final collapse of the par value system in March 1973, the Committee reiterated its conviction that the reformed system should be based on some resurrected par value system. And as late as June 1974, Sir Jeremy Morse, Chairman of the "Bureau" of the Committee of Twenty and of its Deputies, stated that the system described in the Outline of Reform which the Committee had produced "is to be based upon stable but adjustable par values and is to be equipped with intervention and convertibility arrangements which do not belong to widespread floating". It is evident from the same speech that in mid-1974 Jeremy Morse still believed in the return to some par value system. Others still cherish that hope today. One cannot help being struck by the curious parallel between this continuing hope for a return to par values in the 1970's, and the equally unrealistic wish to return to gold in the 1930's on which the World Economic Conference of 1933 foundered.

In the light of these conditions, what is the significance of the agreements finally completed at Jamaica?

### Exchange Rates

Much energy has already been expended on penetrating analyses of the language of the proposed new Article IV of the Fund's charter entitled "Obligations Regarding Exchange Arrangements". I feel it a duty to sound a note of warning here. Article IV is a Franco-American compromise between two opposing points of view. Even though the legal style of the original text has been greatly improved with the help of the Fund's General Counsel, Joseph Gold, the language basically conceals differences instead of revealing agreement. It is, of course, possible — and most certainly to be desired — that future developments and negotiations will bring about a greater degree of consensus on the world's exchange rate regime. Since Article IV is rather verbose, passages will then no doubt be found on which to base these future agreements. But the process cannot be reversed. Exegesis of the language of Article IV will not reveal the nature of these much needed future agreements, which unfortunately do not yet exist.

This is not to say that for the immediate future Article IV does

not do a number of important things. First, it legalizes the present rather varied exchange rate regimes, applied by the member countries. Each Fund member will be entitled to have the exchange arrangement of its choice, as long as it does not prevent effective balance of payments adjustment.

Second, the Article abolishes the par value system, and in addition it creates a barrier against its reintroduction. "The Fund may determine by an 85 per cent majority... that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values". Please note (1) that par values may under these circumstances be "introduced", which clearly means that they do not exist beforehand; (2) that the introduction must be "widespread"; (3) that an 85 per cent majority is required, which gives the United States, with 20 per cent of the voting power, a veto; and (4) that U.S. assent to such an introduction of par values will be further discouraged by the fact that the convertibility obligations of Article VIII have been left untouched. This means that difficult negotiations on the question of convertibility would no doubt have to precede the introduction of stable but adjustable par values.

### Gold

The second basic problem facing the system is the absence of international control over international liquidity. On this score the Jamaica agreement offers no solution. Indeed, it seems to have made such control — national or international — more difficult to achieve than before.

The Interim Committee concentrated its attention in this field almost exclusively on the role of gold. The present Articles of Agreement of the Fund forbid monetary authorities from buying gold at a price higher than the official one. As the gold price on the free market continued to rise after official intervention on the gold market was halted in March 1968 — in a way rather similar to the suspension of official intervention on the exchange markets — the gold holdings of the monetary authorities, in effect, became unusable. However, as a practical matter one could not indefinitely prohibit central banks from dealing at a realistic price in a commodity of which they possessed huge quantities. Thus the real

question became whether the prohibition would be either lifted in a way that would enhance the monetary role of gold, or under such rules and safeguards as would ensure its phasing out as a monetary instrument, so as to increase the possibilities of control over international liquidity.

It should be pointed out that the monetary role of precious metals is an anachronism, dating to preindustrial times. As the Western economies expanded under the impact of the Industrial Revolution, the money supply, embodied up to that time largely in the precious metals, had to be supplemented by paper money of various kinds. The nineteenth-century gold standard was the system that purported to ensure that this paper money behaved as if it were gold itself. In this light, the gold standard, often considered to be the zenith of the monetary role of gold, is more properly regarded as the beginning of the phasing out of that role. For as the quantity of paper money in circulation grew until it far surpassed the quantity of gold in the circulation, it became more and more the value of the paper money that determined the value of gold, and not the other way round.

The monetary disturbances connected with the First World War and the Great Depression further reduced the significance of gold. Instead of basing their policies on movements in monetary gold reserve, governments came to adopt policy aim such as reasonable price stability, full employment, and economic growth, in ways affected to a considerable extent by the theory developed during the Great Depression by Lord Keynes regarding the determination of the level of economic activity. (The present difficulties in the field of employment are due in part to the fact that in playing around too enthusiastically with the new Keynesian toys, people lost sight of other factors, such as a balanced price and profit structure, which are equally important for the maintenance of full employment as the factors to which Keynes called attention and which retain their validity.)

While the phasing out of the monetary role of gold is thus historically inevitable, already far advanced, and in the long run unaffected by decisions taken now, from a practical point of view these will most decidedly affect events in the immediate future. Which way did the decisions go?

On August 30, 1975, the finance ministers of the United States, France, the Federal Republic of Germany, the United Kingdom,

and Japan, meeting on the U.S. presidential yacht *Sequoia*, agreed to abolish the official price of gold. This would permit monetary authorities to engage in gold transactions at any price they see fit. It was further agreed to eliminate all obligations to use gold in transactions with the Fund, and that the Fund would sell one third of its gold holdings. One sixth would be "restituted" at the old official price to all Fund members in proportion to quotas and another sixth would be sold on the market with the profits going to the developing countries, mainly via a Trust Fund. Moreover, the countries in the Group of Ten (industrialized nations) agreed to certain arrangements, outside the Fund Articles but to which other Fund members may adhere, of which the three essential paragraphs are as follows:

1. That there be no action to peg the price of gold.
2. That the total stock of gold now in the hands of the Fund and the monetary authorities of the Group of Ten will not be increased.
- .....
5. That each party agree that these arrangements will be reviewed by the participants at the end of two years and then continued, modified, or terminated. Any party to these arrangements may terminate adherence to them after the initial two-year period".

In essence, these arrangements were identical to the agreement reached among the EEC Ministers at Zeist in the Netherlands in the spring of 1974.

The question of pegging or stabilizing the price of gold is decisive for its future monetary role. Without official intervention the gold price is likely to fluctuate sharply, as during the past years, just like the price of other commodities. But this very price instability makes gold unusable as a monetary asset. There are only seven central banks that have large gold holdings. Their Governors know each other well and have a tradition of close and cordial cooperation. If two of them were to conclude a gold transaction between them in a volatile market, the likelihood is that after a few months, one Governor would have realized a sizable profit at the expense of the other. This is in clear conflict to their normal working relationships. Or, to put the matter in a more analytical way, it is not the business of central banks to engage in speculative commodity transactions.

Without official stabilization of the gold price, gold is unsuitable as a monetary asset, and gold transactions are to be expected only in emergencies.

Whatever objections one might raise against the gold agreement, such as the huge unwarranted increase in international liquidity and the extremely unequal distribution of gold profits, its no-pegging provision would have speeded up the phasing out of gold's monetary role *but for paragraph 5*, binding countries to adhere to these provisions for two years only.

The result of these agreements is an immediate rise in the price at which monetary authorities can deal in gold with one another, and freedom to peg the price or to reduce the price fluctuations after two years, unless the United States succeeds in prevailing upon the European authorities to refrain from such action.

What this means is that the outlook for gold in the next few years is uncertain. This uncertainty about such a key element of the system underlines once again the interim character of the Jamaica agreements; they do not introduce a new monetary system in a meaningful sense. Nevertheless important decisions were reached. The demonetization of gold, desired by the United States, has been avoided by the European countries, and when in need, they can use gold at a vastly increased price, and as a competitor to the dollar. On the other hand, the United States got practically everything it wanted in the field of the exchange rate regime. This is the political deal that was struck at Jamaica.

The developing countries obtained an increase in their voting power in the Fund, an increase in the resources of the Fund from SDR 29 to SDR 39 billion and an immediate liberalization of the regular tranche policies in anticipation of that increase, an easing of the rules concerning the granting of compensatory financing when countries dependent on a few staple commodities experience a sudden fall in export earnings, and a Trust Fund granting loans on concessional terms to the poorest among them.

#### Liquidity Control and the SDR

The Interim Committee of the Fund's Board of Governors did not discuss convertibility, or its milder form of asset settlement, which had occupied so much of the time of its predecessor: the

Committee of Twenty. As noted, these reforms worked out by the Committee of Twenty were designed for a fixed-rate system. Little relevant though has been given to the question of how to control the volume of reserve currencies used as monetary reserves under a flexible exchange rate system.

In a world in which most non-oil producers have to worry about borrowing to cover their current account deficits, the inconvertible dollar has become the international money *par excellence* in spite of much comment to the contrary. This hampers the control over international liquidity, which is rendered even more difficult by the fact that part of the official borrowing leads to a rise in liquidity. Moreover, the sharp movements in the gold price lead to dramatic movements in the total volume of international liquidity. It has been argued that in spite of these difficulties countries can to some extent approach their desired level or reserves by movements of the exchange rate. But there are other, far more powerful considerations, such as the effect on trade, that countries have in mind when managing their exchange rate.

We are thus further away than ever from approaching control over international liquidity. There can be no doubt that this situation is at least contributing to the difficulties in fighting world-wide inflation. Liquidity control is possible only if countries are willing to accept rather strict rules regarding the composition of their monetary reserves, which affect their holdings of both currencies and gold. Full control may well require depositing reserve currencies and gold with the Fund in return for SDRs. But enabling authority to achieve this goal — technically through a so-called Substitution Account — does not form part of the proposed amendment of the Fund's Articles. Indeed, rather than concentrating monetary gold in the Fund, where it is out of sight and does not circulate, the Fund is selling part of its gold to members. And there are no rules about reserve currencies. In these circumstances, the phrase about "making the SDR the principal reserve asset in the international monetary system" (Article VIII, Section 7) has a rather hollow tone.

Apart from reaching the agreements described on exchange rates and gold, while leaving the control over liquidity to another day, the Jamaica conference reached final agreement on a comprehensive amendment of the Fund's Articles, which will simplify, streamline, and update the operations of the Fund. While these amendments are of great importance for the daily work of the Fund, and although

they provide, in many instances, enabling authority which will make it easier for the Fund to adapt its operations to changing circumstances, these amendments do not significantly affect the monetary system as such. The principle of self-amendment by a vote of the Board of Governors, even with a highly qualified majority, has continued to be rejected — rightly so, in my opinion.

The conclusion is that the Jamaica agreement mainly legalizes the situation that had evolved in practice. This is true both with regard to exchange rates and to gold, for central banks had started using gold at near-market prices as collateral for loans. Hence, the implementation of the new amendments will bring little additional change that is fundamental to the international monetary system. But they do provide a basis for constructive future action.

### The Tasks Ahead

Since the change in the exchange rate regime came about as a result of breakdown, not of reform, not only are there no rules on how to operate the new flexible exchange rate regime, but also an agreed philosophy on which to base such rules is lacking.

Under the amendments the Fund is to "exercise firm surveillance over the exchange rate policies of members". This opens the possibility for important and most constructive action by the Fund. Such surveillance can only be meaningful against the background of an agreed conception of proper policies. It will therefore be a most important task for the Fund in the next year or two to develop and reach agreement on such a conception concerning exchange rate policies. In this way, practical rules concerning the new exchange rate regime would be developed on the basis of experience now being obtained.

But the task will not be easy. Some countries, especially the United States, believe that exchange rates should be left to "market forces". I find this view not altogether easy to understand, since the authorities themselves, through their monetary policy, are a most important market force on the short-term money market, whose conditions directly influence the exchange market.

Many other countries consider the exchange rate an important instrument of economic policy, and therefore have "managed" their floating exchange rate. The rather large changes in the exchange

rate between major currencies within a short period, which in a number of cases were clearly inappropriate when related to the fundamental economic situation, have reinforced this view. In either case, Fund surveillance will have to include both monetary and exchange rate policies.

Thus the Jamaica agreement provides an important starting point for further progress in the field of exchange rates. The other main task for the next few years will be to prepare the ground for eventual control over liquidity creation in the form of reserve currencies and gold. Only then could the SDR resume its place as the symbol of more rational monetary arrangements.

A most significant fact has been that through the turmoil of the past years, the need for cooperation instead of unilateral action, let alone economic warfare, has been universally recognized. The Fund has been accepted, as a matter of course, as a main center for such cooperation. If the monetary system has fallen into ill-health for the moment, the Fund as the center of international monetary cooperation has come through the vast changes in full vigor and ready to act more effectively than before under its amended Charter.

*Washington*

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