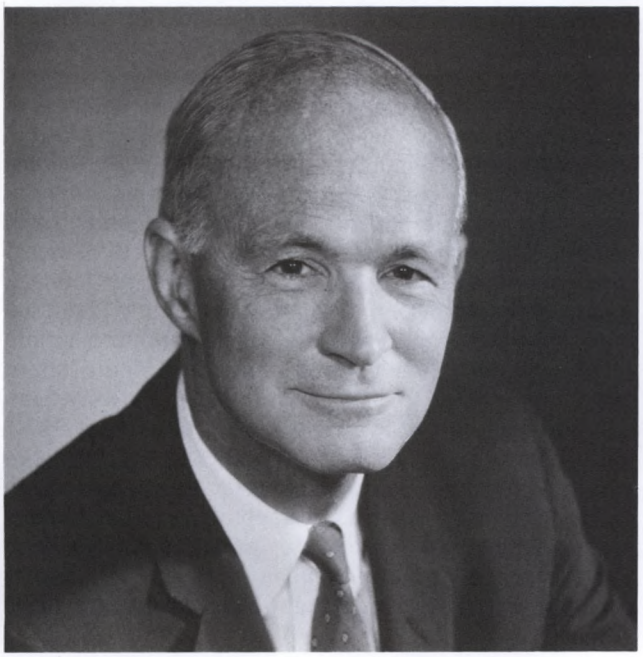
Alfred E. Hayes
President, August 1956 to August 1975



During Hayes' tenure as president, the dollar-centered Bretton Woods system of fixed exchange rates matured, then collapsed, prompting a transition to floating exchange rates. In this address, Hayes discusses the development of international cooperation in foreign exchange market intervention and the prospects for reform of the international monetary system. He recommends that countries work together to ensure exchange rate stability, orderly balance-of-payments adjustment, and the financing of imbalances resulting from the first energy crisis.

The International Monetary System—Retrospect and Prospect by Alfred E. Hayes

Today I would like to share with you a look at the development of the international monetary system since World War II, together with a brief attempt to see what may lie ahead. Let me state at the outset, however, that visibility has rarely been lower than it is now. The whole world economy is being subjected to strains greater than would have been imaginable a few years ago. And, as you know, the International Monetary Fund's Committee of 20[1] found it impossible to give the recent annual meeting of the Fund's governors a full blueprint of a new system. In light of this very uncertain state of affairs, it is especially hard to distinguish those tendencies that are likely to be embodied in whatever new system will emerge some years in the future. However, I think the effort is worth making.

My vantage point for these observations is a favorable one. The Federal Reserve Bank of New York is the operating arm of the Federal Reserve System in the international area and we participate in the Federal Open Market Committee's formulation of policies. The Bank also acts as agent for the Treasury in carrying out most of its foreign exchange and other international transactions. We enjoy close relations with virtually all the central banks and other monetary authorities in the world.

In our vaults are $17 billion of gold (valued at the

[1]The "Committee on Reform of the International Monetary System and Related Issues," better known as the Committee of 20, was created by the Board of Governors of the IMF in 1972 to study proposals for the reform of the international monetary system.

Address delivered before the Business Forum and the Money Marketeers, New York University, New York, November 13, 1974.

official price) held in custody for these monetary authorities — the largest concentration of gold in the world — as well as the bulk of their holdings of U.S. Treasury securities, $60 billion, well over 10 percent of the total U.S. public debt. A very large proportion of their dollar payments pass through our books, and last year the security transactions we carried out for them came to almost $300 billion, about three times the huge total effected for the System Open Market Account.

Since my coming to the Bank in 1956, our international transactions have expanded greatly in volume and our overall international activities have grown in importance. This is one area of our responsibilities that over recent years has involved much of the time and attention of the Bank's top executives. One aspect of this involvement that deserves particular attention is the development of the Federal Reserve swap network.

The early years of the Federal Reserve swap network

This network has turned out to be a major contribution to the international monetary system. In general, it is fair to say that the Federal Reserve swap network has proved its worth under both fixed-rate and managed float arrangements and will probably remain an indispensable feature of whatever may be the future international financial system.

I don't have time to go into the mechanics of the swap transactions, but the essence of the operation is a renewable short-term credit of, say, 90 days' duration from one central bank to another. Before the inception of the Federal Reserve swap network in 1962, such central bank swap transactions had been arranged from time to time on an ad hoc basis, notably during the run on sterling in 1961.

In early 1962, the Federal Reserve, with the strong support of the U.S. Treasury, concluded that there would be a continuing and probably increasing need for central banks to help each other out by providing short-term credits to partner central banks whose currencies might come under selling pressure from time to time for a broad range of reasons, from seasonal weakness to unwarranted speculative attacks. It seemed to us in the Federal Reserve that the best way of dealing with this problem was to arrange well in advance for reciprocal lines of credit linking up the major central banks in the world with the Federal Reserve, whose currency, the dollar, was the intervention currency for our foreign central bank partners. We felt, and I think correctly, that by setting up these reciprocal lines of credit in a highly visible way, and in advance rather than waiting until they were actually needed, we could provide an assured reinforcement of the international financial system. I hasten to add that neither the Federal Reserve nor any of its central bank partners in this endeavor ever had any illusion that the swap network could do more than provide such a reinforcement. After all, the continued operation of any stable international financial system depends fundamentally upon the ability of the United States and other major trading nations to maintain reasonable equilibrium in their balance of payments.

From April 1962 until the closing of the gold window in August 1971, the Federal Reserve swap network grew from a single $50 million swap arrangement with the Bank of France to a $11.7 billion credit system embracing 14 central banks and the Bank for International Settlements. During this decade, many countries saw their balance of payments swing from surplus into deficit and back. As various currencies came under temporary selling pressure, the swap network was called upon to make available an overall total of $27.1 billion of swap credits. Of this total, $11.8 billion were drawings by the Federal Reserve, and $15.4 billion drawings by our partners. In general, the swap credits accomplished their purpose of enabling countries to ride through speculative squalls and other short-term difficulties, and the repayment record was generally excellent.

The defense of sterling in the 1960s

Of the many financial events of the 1960s in which the swap network played a role, the defense of sterling merits special attention. From the restoration of convertibility in 1958 until Britain's devaluation of sterling in 1967, sterling was the currency that caused by far the greatest concern in financial circles. Sterling's malady was not a steady one, for it was punctuated by periods of strong recovery and restored faith — only to be followed by new difficulties. I shall not try to analyze the reasons for sterling's recurrent weakness. But since it had a reserve currency role second only to that of the dollar, its fate involved the whole monetary system and was a matter of keen interest to other countries. There was wide recognition of the danger that a devaluation of the pound would prove to be a prelude to speculative attacks against the dollar. As it turned out, these fears were borne out almost immediately after sterling was actually devalued. In recognition of this interdependence, the Federal Reserve participated with other major central banks in the defense of sterling. Naturally only the country whose currency is in question can make the basic political decision to devalue or revalue. But as long as the will to defend the sterling parity continued within the United Kingdom, I believe our concerted efforts in its behalf were thoroughly justified.

During this period, the drawings by the Bank of England on the Federal Reserve swap network and on other ad hoc central bank credit arrangements fluctuated quite widely as sterling moved up and down. The reliance on central bank credit did not obscure the question of exchange rate adjustment. In fact, six months before the devaluation of sterling in November 1967, the Bank of England had completely paid off all outstanding central bank debt. Incidentally, in the case of the dollar, the major buildup of swap indebtedness of the Federal Reserve, totaling more than $3 billion at the time of the closing of the gold window, was incurred only during the very last weeks of dollar convertibility.

The inconvertible dollar

The relative trade position of the United States had begun to deteriorate in the late 1950s and early 1960s, and vast sums were already moving abroad for investment to take advantage of faster growing markets and lower costs and to jump Common Market barriers. But it was the sharp acceleration of U.S. inflation after mid-1965, together with the sterling devaluation, that really brought dollar convertibility into serious doubt. Whether or not the decision of August 1971 could have been avoided or deferred through timely measures by all the major trading nations before the final speculative wave struck the dollar will be debated for a long time. In any event, cutting the tie between the dollar and gold had a traumatic effect on the international monetary system from which it has not yet recovered. Because of its primacy as a trading and investment currency, the dollar had become by far the principal medium for official intervention in the exchange markets and also by far the largest component of monetary reserves except for gold.

With all respect for the valiant and painstaking efforts to establish the SDR as an acceptable substitute, it cannot take the dollar's place as the chief vehicle for official intervention. Moreover, it must be acknowledged that gold still represents the most cherished form of monetary reserves in a great many countries.

After the tie to gold was cut, it came to be quite widely held that we need feel no concern as to how low the dollar might sink in the exchange markets, even under periodic speculative attacks, because a cheaper dollar would assure a better competitive trade position for U.S. products. The philosophy of "benign neglect" overlooked the serious inflationary impact that a depreciation of the dollar could have, and indeed did have, on the domestic price level. It also neglected the fact that the bulk of the world's trade was denominated in dollars, the largest financial markets were dollar markets, and most countries of the world still looked to the dollar as their main monetary anchor. An anchor that bobbed about wildly in the heavy seas was not very helpful. Furthermore, this philosophy posed the danger of encouraging a spirit of competitive exchange rate adjustments and monetary controls, which if it had developed, could have destroyed much of the fabric of economic cooperation that had been woven so carefully in the years following World War II.

The Federal Reserve swap network lay dormant for slightly more than a year after the closure of the gold window while the negotiation and launching of the Smithsonian Agreement[2] got under way. By July of 1972, however, it had become clear that the United States could not leave the entire burden of supporting the Smithsonian dollar rate to foreign governments, and so the Federal Reserve resumed intervention in the exchange markets, again relying upon the swap network to meet its needs for foreign currencies.

In early 1973, another tidal wave of speculation swept through the exchange markets, and in February 1973 it was decided to devalue the dollar for the second time. A modest amount of Federal Reserve swap debt incurred just prior to the devaluation was quickly repaid, but intervention was not resumed as both the United States and the major European countries agreed in March 1973 to let the dollar float. Unfortunately, the dollar did not float, but sank precipitously, as speculative pressures cumulated. By early July 1973 exchange trading in the dollar was grinding to a standstill. At this critical juncture, the Federal Reserve was again called upon by both the U.S. and European governments to resume exchange market intervention, backed up by a major enlargement of the swap network to nearly $18 billion. (The total now stands at almost $20 billion.) The very announcement of this policy shift from a free to a managed float of the dollar brought about an immediate strong recovery of dollar rates. From then on the tide began to turn.

Over the succeeding year, Federal Reserve intervention to support the dollar amounted to somewhat more than $1 billion, mainly financed by drawings on the swap network, all of which were repaid in less than six months' time. Today, as the markets realize that the authorities are fully prepared to show their presence, violent speculation has subsided and exchange markets are orderly. The oil embargo and skyrocketing oil prices have, of course, contributed to sizable swings in the exchange rates over the past year.

[2]The Smithsonian Agreement of December 1971 realigned currencies by devaluing the dollar against gold and revaluing major foreign currencies against the dollar. The Agreement also established the freedom of countries to declare central exchange rates against foreign currencies rather than parities against gold and provided for a wider band of permissible exchange rate fluctuations around central rates.

The financial aspects of the energy crisis

The quadrupling of the price of oil has altered the whole international financial outlook more violently than any other event in many decades. I need not remind this audience that the magnitudes involved in the prospective shift of monetary reserves to the oil-producing countries really stagger the imagination. No wonder there is widespread pessimism about devising arrangements that can handle such flows. Even the most successful arrangements would still mean overwhelming burdens of debt service for many countries, both developing and developed, that could not be carried indefinitely. This prospect underlines the great need to bring about — through cooperative measures by oil producers and consumers alike — a reduction of this huge imbalance in international payments as rapidly as possible, with a view to its elimination in the foreseeable future.

This may seem a dreamer's objective, but I see it as the only way out and I would hope that the joint efforts necessary toward this end will get under way before too long. The aim should be a two-pronged reduction of the imbalance: to reduce the volume of oil payments, and in the longer run, to speed up the oil-exporting countries' purchases of goods and services.

Regarding the gross flow of oil payments, much has been said of the need to achieve a lower level of oil prices, and I endorse this aim. I would also like to see a greater emphasis on effective measures to conserve fuel, however unpopular they might be, and on the development of alternative energy sources.

The other side of the imbalance, the inability of the oil-exporting countries to spend their newly found wealth promptly on imports from abroad, is clearly even more difficult to tackle and has to be viewed in a longer context. A great deal of skepticism prevails regarding the possibility of ever raising the level of the oil-exporting countries' imports anywhere near the value of their oil receipts. Their imports, however, are already rising at a surprisingly rapid rate. And for the future, massive international programs of economic development not just in individual countries, but in entire regions, such as the Middle East, should make it possible for the oil-consuming countries to make the transfers of resources necessary to pay for the oil they require. At the same time, of course, such programs would help the oil-exporting countries speed their efforts to utilize their underground resources for the benefit of their coming generations.

In the meantime, while the large imbalances continue, the world must find better ways for financing them. So far, private markets and institutions have taken care of most of the oil payments without undue difficulty. But it would be a bad mistake to assume that they can continue to do so much longer. For one thing, the oil payments are now running at a much higher rate than even in the first half of the year, apparently at least 50 percent higher. No doubt the commercial banking system will retain a role, but from now on a variety of public channels will have to be relied upon to an increasing extent. This will be necessary if we are to avoid serious dislocations in the weaker — but not necessarily the smallest — nations, and the consequences these would entail for the trading and investing world in general.

The term "recycling" has become very popular in recent months. To me it is a misnomer — or worse — for the problem at hand. It tends to conceal the basic question of who should assume the credit risk in lending to the countries beset with economic difficulties.

Notwithstanding the risks and difficulties involved, if the United States receives a large share of the investment flows from the oil producers, as a good many market observers think quite likely, careful thought will have to be given to means of channeling some portion of these flows to less fortunate countries experiencing big oil deficits — and this will call for political awareness as much as technical skill.

More fundamentally, the oil-exporting countries will have to take on themselves an increasing share of the risk of the financing of the oil deficits through bilateral credits and grants. There are already some encouraging signs to this effect. These countries will probably also wish to undertake a growing volume of the oil-deficit financing through international organizations. There would thus seem to be a major role in the financing of the oil deficits for these organizations, such as the International Monetary Fund and the World Bank and their affiliates, or even for new bodies.

Reflections on Bretton Woods

Before I attempt to look further ahead at the prospects for reshaping the international monetary system, I should like to reflect on Bretton Woods.

In the last few years, views as to the merits of greater "flexibility" in the international monetary system have exhibited substantial swings. The Bretton Woods system, based on mutually agreed and preestablished par values for all currencies, embodying a clear code of international monetary behavior, monitored and guided by the International Monetary Fund and shared in by all the principal countries of the non-Communist world, was widely disparaged after the closing of the gold window in August 1971. For a while it was the conventional wisdom to welcome a brave new world in which exchange rates would no longer be instruments of economic policy but would be left largely to seek their own levels in the market. This new world, it was thought, would no longer have to fear exchange "crises" in

which the dams finally break after large-scale efforts of central banks to maintain untenable rates prove futile. Moreover, it was claimed, governments would no longer have to compromise domestic economic policies to protect exchange rates. Inflationary consequences of large payments imbalances could be avoided, as surplus countries would no longer face the need for huge support operations. At the same time, deficit countries could escape having to restrain domestic spending to stem vast losses of reserves.

However, it didn't work out that way. In the first place, during the brief periods since the end of Bretton Woods when exchange markets were on their own, it was not surprising that speculative pressures tended to cumulate and exchange rates were driven far from any likely equilibrium levels. Thus serious exchange troubles were not banished but took the form of violent movements of exchange rates rather than violent movements of exchange reserves. To be sure, surplus countries did not have to face the inflation potential of unwanted reserve gains. But excessive exchange rate swings aggravated inflation in deficit countries without bringing fully corresponding price moderation to the surplus countries whose exchange rates were appreciating. The experience also showed that the hope of freeing domestic policies from external constraint was largely illusory.

In any event, after the Bretton Woods system was abandoned, it became clear that exchange rates were still a matter of major political and economic importance in every country. Hardly any government or its monetary authority was willing for very long to let its own currency float entirely in response to market forces. In fact, since March 1973 (when floating began) official intervention in the exchange markets to moderate exchange rate fluctuations has totaled some $52 billion by the Group of Ten countries alone.

Thus, in my view, the recent experience has underlined some of the positive aspects of the Bretton Woods system. By providing an international framework for exchange rate changes, with the backing of substantial amounts of credit, both automatic and discretionary, that system made it possible for such changes to be made without international discord and with a minimum of restrictions on the international movements of goods, services, and capital. To be sure, as time went on, exchange rate stability sometimes turned out to be rigidity. It is, of course, a truism that no international system can either compensate for the inability of *sovereign member* states to manage their affairs properly or offset their unwillingness to pool some of their sovereignty for the benefit of a wider community. More fundamentally, what brought the Bretton Woods system to an end were the asymmetries in the adjustment process that increasingly came to the fore: on the one hand, the asymmetry between the strong pressures exerted on debtor countries and the weaker pressures felt by creditor countries, and on the other hand, the asymmetry in the meeting of deficits of reserve currency countries and countries without such currencies. But as we look ahead, these shortcomings should not blind us to the old system's very considerable contributions to an unprecedented growth in world commerce.

Prospects for the international monetary system

As I said at the outset, the past year's events have made it even more difficult than before to foresee the shape of tomorrow's monetary system. I was always of the view that, once the key element of the postwar system no longer existed, that is, the link between the dollar and gold, it would not prove possible to agree in advance to a complete new system. Rather it would be necessary to rebuild gradually on an ad hoc, experimental basis, with various blocks of the new system being put in place as they proved their worth. The oil problem merely strengthens my conviction in this regard. If asked to mention specifics of the system that will eventually develop, about all I can do is to cite a few principles that I think must be adhered to and to point out some areas that call for special attention and study.

We need agreed-upon rules of conduct and balanced pressures to help enforce them. The area of exchange rate policies is crucial to the well-being and growth of the world economy, and fortunately it is one where we can begin promptly, building upon our recent experiences. A country's exchange rate is too vital an element of its economic welfare to be left in the hands of often capricious exchange markets. At the same time, it affects other countries as well, particularly among the major trading nations. As a result, exchange rate relationships bear the seed of conflicting national interests. Unless these are reconciled, no monetary system can function properly. A framework of greater exchange rate stability is one that lends itself best to such a reconciliation. But reasonable exchange rate stability should be a primary aim in its own right. With it, exchange markets can function better, world trade and payments have a more assured basis on which to grow, and national governments have the opportunity to carry out domestic policies in a climate of relative certainty. And it must not be forgotten that such stability is in the interest of the developing countries, as well as of the major industrial powers. The developing countries have in recent years been seriously exposed to violent swings of exchange rates that were not of their making. No wonder they have been quite vocal in urging a return to a system in which there is some reasonably

stable framework to which they can tie their own currencies.

As we move toward greater exchange rate stability, and I believe we are doing so, we must not overlook the need for orderly procedures for changes in rates. The balance-of-payments adjustments that are necessary as the world economy grows and develops, at times at a different pace in individual countries, cannot always be made through domestic policies alone. But to give such policies a chance to be effective requires international credit lines that can be utilized as and when needed. The IMF quota facilities, the Common Market's Fund, the Federal Reserve swaps, and other central bank credit lines are essential components of an orderly monetary system.

Thus, as I see it, exchange rate stability, orderly balance-of-payments adjustments, and a solid network of international credit arrangements are some of the buildings blocks for the new system. Beyond this, a multitude of problems such as the role of multinational corporations and banks, surveillance of the Eurocurrency markets, better coordination of national monetary policies, and the plight of the poorest among the developing countries need thorough attention.

Progress on all these fronts is unlikely to be as rapid as we would like. Unfortunately, the oil problem and the worldwide disease of virulent inflation, and now the fears of recession, enhance the risk that short-sighted nationalistic tendencies might come to the fore.

Of one thing I am certain, however. The world we live in is one where interdependence is a vital reality that we cannot afford to overlook. We must bend every effort to find cooperative and durable answers to our major economic problems. In the specialized area of financial and monetary cooperation, the world's monetary authorities have made a good start in the past few decades. In particular, I can attest from personal experience that central bankers have learned to work together intimately and effectively in matters involving the exchange markets. I see every reason to believe that effective means of international cooperation will be found in this very difficult new world we face today.