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Some Essentials of International Monetary Reform

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SOME ESSENTIALS OF INTERNATIONAL MONETARY REFORM

On August 15 of last year, in the face of an unsatisfactory economic situation, the President of the United States acted decisively to alter the nation's economic course. The new policies, especially the decision to suspend convertibility of the dollar into gold or other reserve assets, were bound to have far-reaching consequences for international monetary arrangements. New choices were forced on all countries.

The next four months gave all of us a glimpse of one possible evolution of the international economy. Since exchange rates were no longer tied to the old par values, they were able to float--a prescription that many economists had favored. However, last fall's floating rates did not conform to the model usually sketched in academic writings. Most countries were reluctant to allow their exchange rates to move in response to market forces. Instead, restrictions on financial transactions proliferated, special measures with regard to trade emerged here and there, new twists crept into the pattern of exchange rates, serious business uncertainty about governmental policies developed, fears of a recession in world economic activity grew, and signs of political friction among friendly nations multiplied.

Fortunately, this dangerous trend toward competitive and even antagonistic national economic policies was halted by the Smithsonian Agreement. Despite recent developments in Vietnam, which may cause some uneasiness in financial markets for a time, the Smithsonian realignment of currencies is, in my judgment, solidly based. It was worked out with care by practical and well-informed men, and I am confident that the central banks and governments of all the major countries will continue to give it strong support.

Developments in the American economy since last December have been encouraging. Aggregate activity in the United States has begun to show signs of vigorous resurgence. Price increases have moderated, and our rate of inflation has recently been below that of most other industrial countries. Moreover, the budget deficit of the Federal Government will be much smaller this fiscal year than seemed likely three or four months ago. These developments have strengthened the confidence with which business-men and consumers assess the economic outlook. International confidence in turn is being bolstered by the passage of the Par Value Modification Act, by the convergence of short-term interest rates in the United States and abroad, and by some promising signs of improvement in the international financial accounts of the United States.

With the Smithsonian Agreement and other indications of progress behind us, it is necessary now to move ahead and plan for the longer future. The Smithsonian meeting was pre-eminently concerned with realigning exchange rates. It did not attempt to deal with structural weaknesses in the old international monetary system. Yet they must eventually be remedied if we are to build a new and stronger international economic order.

We all have to ponder this basic question: Given the constraints of past history, what evolution of the monetary system is desirable and at the same time practically attainable? For my part, I should like to take advantage of this gathering to consider some of the elements that one might reasonably expect to find in a reformed monetary system.

First of all, a reformed system will need to be characterized by a further strengthening of international consultation and cooperation among governments. Our national economies are linked by a complex web of international transactions. Problems and policies in one country inevitably affect other countries. This simple fact of interdependence gives rise to constraints on national policies. In a smoothly functioning system, no country can ignore the implications of its own actions for other countries or fail to cooperate in discussing and resolving problems of mutual concern. The task of statesmanship is to tap the great reservoir of international goodwill that now exists and to make sure that it remains undiminished in the future.

Sound domestic policies are a second requirement of a better world economic order. A well constructed international monetary system should, it is true, be capable of absorbing the strains caused by occasional financial mismanagement in this or that country--such as are likely to follow from chronic budget deficits or from abnormally large and persistent additions to the money supply. But I doubt if any international monetary system can long survive if the major industrial countries fail to follow sound financial practices. In view of the huge size of the American economy, I recognize that the economic policies of the United States will remain an especially important influence on the operation of any international monetary system.

Third, in the calculable future any international monetary system will have to respect the need for substantial autonomy of domestic economic policies. A reformed monetary system cannot be one that encourages national authorities to sacrifice either the objective of high employment or the objective of price stability in order to achieve balance-of-payments equilibrium. More specifically, no country experiencing an external deficit should have to accept sizable increases in unemployment in order to reduce its deficit. Nor should a surplus country have to moderate its surplus by accepting high rates of inflation. Domestic policies of this type are poorly suited to the political mood of our times, and it would serve no good purpose to assume otherwise.

I come now to a fourth element that should characterize a reformed monetary system. If I am right in thinking that the world needs realistic and reasonably stable exchange rates, rather than rigid exchange rates, ways must be found to ensure that payments imbalances will be adjusted more smoothly and promptly than under the old Bretton Woods arrangements.

The issues here are many and complex. There was a consensus at the Smithsonian meeting that wider margins around parities can help to correct payments imbalances, and should prove especially helpful in moderating short-term capital movements--thereby giving monetary authorities somewhat more scope to pursue different interest-rate policies. Our experience has not yet been extensive enough to permit a confident appraisal of this innovation. It is clear, however, that no matter how much the present wider margins may contribute to facilitating the adjustment of exchange rates to changing conditions, the wider margins by themselves will prove inadequate for that purpose.

We may all hope that at least the major countries will pursue sound, noninflationary policies in the future. We should nevertheless recognize that national lapses from economic virtue will continue to occur. In such circumstances, changes in parities--however regrettable--may well become a practical necessity. Moreover, even if every nation succeeded in achieving noninflationary growth, structural changes in consumption or production will often lead to shifts in national competitive positions over time. Such shifts will also modify the pattern of exchange rates that is appropriate for maintaining balance-of-payments equilibrium.

In my judgment, therefore, more prompt adjustments of parities will be needed in a reformed monetary system. Rules of international conduct will have to be devised which, while recognizing rights of sovereignty, establish definite guidelines and consultative machinery for determining when parities need to be changed. This subject is likely to become one of the central issues, and also one of the most difficult, in the forthcoming negotiations.

Let me turn to a fifth element that should characterize a reformed monetary system. A major weakness of the old system was its failure to treat in a symmetrical manner the responsibilities of surplus and deficit countries for balance-of-payments adjustment. With deficits equated to sin and surpluses to virtue, moral as well as financial pressures were very much greater on deficit countries to reduce their deficits than on surplus countries to reduce surpluses. In actual practice, however, responsibility for payments imbalances can seldom be assigned unambiguously to individual countries. And in any event, the adjustment process will work more efficiently if surplus countries participate actively in it. In my view, all countries have an obligation to eliminate payments imbalances, and the rules of international conduct to which I referred earlier will therefore need to define acceptable behavior and provide for international monitoring of both surplus and deficit countries.

Sixth, granted improvements in the promptness with which payments imbalances are adjusted, reserve assets and official borrowing will still be needed to finance in an orderly manner the imbalances that continue to arise. Looking to the long future, it will therefore be important to develop plans so that world reserves and official credit arrangements exist in an appropriate form and can be adjusted to appropriate levels.

This brings me to the seventh feature of a reformed international monetary system. It is sometimes argued that, as a part of reform, gold should be demonetized. As a practical matter, it seems doubtful to me that there is any broad support for eliminating the monetary role of gold in the near future. To many people, gold remains a great symbol of safety and security, and these attitudes about gold are not likely to change quickly. Nevertheless, I would expect the monetary role of gold to continue to diminish in the years ahead, while the role of special drawing rights increases.

The considerations which motivated the International Monetary Fund to establish the SDR facility in 1969 should remain valid in a reformed system. However, revisions in the detailed arrangements governing the creation, allocation, and use of SDRs will probably be needed. In the future, as the SDRs assume increasing importance, they may ultimately become the major international reserve asset.

Next, as my eighth point, let me comment briefly on the future role of the dollar as a reserve currency. It has often been said that the United States had a privileged position in the old monetary system because it could settle payments deficits by adding to its liabilities instead of drawing down its reserve assets. Many also argue that this asymmetry should be excluded in a reformed system. There thus seems to be significant sentiment in favor of diminishing, or even phasing out, the role of the dollar as a reserve currency. One conceivable way of accomplishing this objective would be to place restraints on the further accumulation of dollars in official reserves. If no further accumulation at all were allowed, the United States would be required to finance any deficit in its balance of payments entirely with reserve assets.

I am not persuaded by this line of reasoning, for I see advantages both to the United States and to other countries from the use of the dollar as a reserve currency. But I recognize that there are some burdens or disadvantages as well. And in any event, this is an important issue on which national views may well diverge in the early stages of the forthcoming negotiations.

I come now to a ninth point concerning a new monetary system, namely, the issue of "convertibility" of the dollar. It seems unlikely to me that the nations of the world, taken as a whole and over the long run, will accept a system in which convertibility of the dollar into international reserve assets--SDRs and gold--is entirely absent. If we want to build a strengthened monetary system along one-world lines, as I certainly do, this issue will have to be resolved. I therefore anticipate, as part of a total package of long-term reforms, that some form of dollar convertibility can be re-established in the future.

I must note, however, that this issue of convertibility has received excessive emphasis in recent discussions. Convertibility is important, but no more so than the other issues on which I have touched. It is misleading, and may even prove mischievous, to stress one particular aspect of reform to the exclusion of others. Constructive negotiations will be possible only if there is a general disposition to treat the whole range of issues in balanced fashion.

We need to guard against compartmentalizing concern with any one of the issues, if only because the various elements of a new monetary system are bound to be interrelated. There is a particularly important interdependence, for example, between improvements in the exchange-rate regime and restoration of some form of convertibility of the dollar into gold or other reserve assets. Without some assurance that exchange rates of both deficit and surplus countries will be altered over time so as to prevent international transactions from moving into serious imbalance, I would deem it impractical to attempt to restore convertibility of the dollar.

My tenth and last point involves the linkage between monetary and trading arrangements. We cannot afford to overlook the fact that trade practices are a major factor in determining the balance-of-payments position of individual nations. There is now a strong feeling in the United States that restrictive commercial policies of some countries have affected adversely the markets of American business firms. In my judgment, therefore, the chances of success of the forthcoming monetary conversations will be greatly enhanced if parallel conversations get under way on trade problems, and if those conversations take realistic account of the current and prospective foreign trade position of the United States.

In the course of my remarks this morning I have touched on some of the more essential conditions and problems of international monetary reform. Let me conclude by restating the elements I would expect to find in a new monetary system that met the test of both practicality and viability:

> First, a significant further strengthening of the processes of international consultation and cooperation;

Second, responsible domestic policies in all the major industrial countries;

Third, a substantial degree of autonomy for domestic policies, so that no country would feel compelled to sacrifice high employment or price stability in order to achieve balance-of-payments equilibrium;

Fourth, more prompt adjustments of payments imbalances, to be facilitated by definite guidelines and consultative machinery for determining when parities need to be changed;

Fifth, a symmetrical division of responsibilities among surplus and deficit countries for initiating and implementing adjustments of payments imbalances;

Sixth, systematic long-range plans for the evolution of world reserves and official credit arrangements;

Seventh, a continued but diminishing role for gold as a reserve asset, with a corresponding increase in the importance of SDRs;

Eighth, a better international consensus than exists at present about the proper role of reserve currencies in the new system;

Ninth, re-establishment of some form of dollar convertibility in the future;

And finally, tenth, a significant lessening of restrictive trading practices as the result of negotiations complementing the negotiations on monetary reform.

I firmly believe that a new and stronger international monetary system can and must be built. Indeed, I feel it is an urgent necessity to start the rebuilding process quite promptly. It is not pleasant to contemplate the kind of world that may evolve if cooperative efforts to rebuild the monetary system are long postponed. We might then find the world economy divided into restrictive and inward-looking blocs, with rules of international conduct concerning exchange rates and monetary reserves altogether absent.

As we learned last fall, a world of financial manipulations, economic restrictions, and political frictions bears no promise for the future. It is the responsibility of financial leaders to make sure that such a world will never come to pass.

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