For Release on Delivery

(Approximately 9:00 a.m.,
Tuesday December 29, 1964)

The Evolving International Monetary Mechanism:

The Report of the Group of Ten

Remarks by J. Dewey Daane

Member, Board of Governors of the Federal Reserve System

Before the American Economic Association

Chicago, Illinois

on Tuesday, December 29, 1964

The Evolving International Monetary Mechanism:

The Report of the Group of Ten

The general topic for today's panel, "The Evolving International Monetary Mechanism" itself suggests what is to me the essential achievement of the Report of the Group of Ten. For the Report represents a further contribution to the orderly evolution of the international monetary mechanism rather than to a revolutionary and drastic break with the past. It constitutes both an approving look backward by financial officials at how the system has evolved and a questing look forward at how it can and may evolve in the future--stressing both new and old elements which may serve to give form and substance to an appropriately evolving mechanism. Not the least of those elements is the growth of international financial cooperation and the mutual acceptance of responsibility for the shaping of the system.

With this particular audience, I do not need to review in detail the Group of Ten Report (Ministers Statement and Deputies Annex) issued last August. Briefly, the most significant conclusions and recommendations of the Report are:

> <u>First</u>, a conclusion that the present system as it has evolved until now has shown impressive flexibility and adaptability, with a reaffirmation of faith in the proven value of its underpinnings in terms of fixed exchange rates and the present established price of gold.
>
> <u>Second</u>, a judgment that international liquidity defined as the entire spectrum of resources available for financing payments imbalances, and taking into account a recommended and prospective increase in IMF quotas, is fully adequate for the present and near-term future.

Third, to ensure this, a call for a moderate general overall increase in IMF quotas, plus selective increases for those countries whose quotas are clearly out of line--thus adding considerably to the credit facilities segment of the liquidity spectrum.

Fourth, to further strengthen international cooperation, formalizing some of the more recent innovations and techniques, through the process of "multilateral surveillance of bilateral financing and liquidity creation".

Fifth, to make a new study with a view toward improving the adjustment process, so importantly determinative of liquidity needs.

Sixth, and finally, to undertake a study of the possible need for additional owned reserves and of the various ways in which that need might be met.

In this panel's limited time and space for the Report of the Group of Ten, I can only touch upon some of the more significant aspects of each of these major facets of the Report.

Proven Value of Fixed Exchange Rates and Established Gold Price

First of all, it seems to me that some of the philosophy underlying the Group of Ten Report with respect to fixed exchange rates and the established price of gold is worth noting. In outlining the frame of reference for the study the Ministers and Governors of the Group of Ten had stressed the proven value of fixed exchange rates and the established gold price. The Deputies of the Ten examined the principal relevant considerations and in their own discussions reiterated the need for both. As to the gold price they concluded that changing it would be a crude and arbitrary way of trying to increase liquidity, would run the clear risk of reducing liquidity, and would be definitely damaging to the present monetary system.

As to a system of fluctuating exchange rates, the Deputies agreed it would be undesirable for a number of reasons. In their view it would adversely affect internal monetary stability because of the absence of balance of payments discipline and the effects on the general price level when the exchange rate changes. They also felt that such a system would introduce an additional element of uncertainty (and cost) into international trade and investment; in practice, would stimulate speculation and disequilibrating capital flows; and would seriously enlarge the risks inherent in foreign trade. Its broad effect, they agreed, would be to restrict rather than to expand international transactions, and to encourage national isolation rather than increased economic integration internationally.

Functioning of the Present System and Present Adequacy of Liquidity

Second, as to the functioning of the present system, the G-10 Report emphasizes that it "has shown a great capacity for adapting itself to growth and change, has facilitated the remarkable economic progress achieved since the war, and has withstood with success periods of political and other strain although many countries are still faced with inflationary pressures and others still have unemployed resources". The Report points up how the reserve currencies have, in an evolutionary way, become an important supplement to gold, not as a result of deliberate planning but through a gradual process reflecting first private and subsequently official practices. The Report further stresses the integral role of growing international cooperation in the functioning of the system, with the International Monetary Fund providing a focal point. Related to this--and one of the more significant products of the studies of the Ten--has been the progress on the conceptual front concerning international liquidity, with general recognition in the Report of the broad spectrum of resources available to the monetary authorities, ranging from gold and foreign exchange reserves to a wide variety of credit facilities. In particular there was special recognition of the reserve character of IMF gold tranches and of Roosa-bonds.

Reflecting this favorable view of the development of the present system, and recognizing the increased role of credit facilities,[1/] both present and prospective, the Report of the Ten reaffirmed the view that the overall liquidity of the system seemed fully adequate for the present and immediate future.

Added Credit Facilities

Third, and related to the greater recognition of the role of the credit facilities component of liquidity and the central position of the IMF, the G-10 Report called for a moderate general overall increase in Fund quotas plus selective increases for those countries whose quotas are clearly out of line. Such increases are already in process of implementation in the Fund Board as a result of the resolution adopted by the Fund's Governors at their Tokyo meeting. This will reinforce

1/ Of the $20 billion growth of total world liquidity since the advent of the era of currency convertibility at the end of 1958, only about two-fifths took the traditional form of gold and foreign exchange, while other similar type assets and credit availability accounted for three-fifths.

the Fund's resources in usable currencies which have fallen to relatively low levels. It will place the Fund in a more adequate position to cope with expanded credit needs associated both with the substantial enlargement of the world economy that has taken place since the last general increase in quotas in 1959 and with the larger needs of a convertible currency world. Most consistently a 25 per cent increase in Fund quotas has been mentioned. Together with selective increases, this would add some 4 to 5 billion dollars to the resources of the IMF.

Further Strengthening of International Cooperation

Another major recommendation in the G-10 Report--also in process of implementation--was the proposal to continue and enhance international financial cooperation, already the hallmark of the postwar international monetary system, through "multilateral surveillance of bilateral financing and liquidity creation". In the first instance "multilateral surveillance" simply means a decision among the Ten to exchange information more promptly and regularly regarding means of financing any surpluses or deficits. But it means more than this against the background of the increased financial cooperation that we in the United States, along with our European colleagues, have been experiencing and benefiting from during the past several years. Such cooperation reflects the close consultation, and mutual appraisal of financial policies impinging on international payments flows, in Working Party-3 of OECD, in meetings of the Ministers and Governors of the Group of Ten, and in monthly meetings at Basle of the Central Bank Governors.

The results of this increased financial cooperation are apparent in the agreement among the Group of Ten to participate in the "General

Arrangements to Borrow", providing a sizeable addition to Fund resources; in the ad hoc, Basle type, arrangements in which central banks have provided assistance bilaterally; in the network of Federal Reserve swaps and stand-by swap arrangements, now totalling over $2 billion; in the investment of over $1 billion in Roosa-bonds; and, most recently and dramatically, in the $3 billion of credit to the United Kingdom arranged by 11 countries.

Multilateral surveillance adds to and strengthens this cooperative process; in a sense we have substituted for the sometimes harsh and disruptive discipline of the gold standard a process of multilateral review and cooperative assistance that assures possible further elaboration and use of the new types of bilateral and other credit facilities that have been developed in recent years. The recent United Kingdom situation provides a clear illustration of this process in action. In early November there was a searching review of the British economic and financial situation, both domestic and external, in the Economic Policy Committee of the OECD and in Working Party-3. Following this review, agreement was reached among the Group of Ten looking to an activation of the GAB so as to provide supplementary resources to the IMF for use in meeting any drawing by the United Kingdom under its existing stand-by arrangement with the IMF. Later, when speculation against sterling threatened a major crisis, the other countries were sufficiently informed to move promptly without the need for further formal consultation.

This most recent action clearly demonstrates, even to the most skeptical, the reality of international financial cooperation and the value of ad hoc credit arrangements in supporting the stability of the international financial system. For despite the sting of the British action imposing a 15 per cent import surcharge, the principal countries were able within a 24-hour period to raise a fund that more than doubled British external resources in support of the U.K.'s determination to defend the pound sterling against a massive speculative attack.

Adjustment Process

At an early stage in their studies the Group of Ten took cognizance of the close inter-relationship between the need for liquidity and the speed and efficiency of the process of adjusting imbalances. It is widely recognized, and was emphasized in the Group of Ten Report, that there is a close, two-way connection between the adjustment process and the amount of international liquidity needed. The trick, of course, is to insure that the international financial system can and will provide individual countries with enough liquidity to facilitate an orderly process of adjustment, without recourse to undesirable deflationary actions or "beggar-my-neighbor" policies, but not so much as to enable countries to ignore the need for internal adjustments to restore equilibrium.

Recognizing these inter-connections, the Group of Ten report recommended that Working Party-3 of OECD undertake a study of the process of adjustment involved in correcting imbalances in international payments, with a view to determining appropriate policies for avoiding or minimizing such imbalances. Again, this study is already underway with WP-3 reviewing its scope and frame of reference.

Creation of Reserve Assets

Finally, the group set up, within its own framework, a Study Group on the Creation of Reserve Assets. Although there was some difference in view as to the extent to which future needs for international liquidity could and should be met largely through continuing expansion of credit facilities rather than of owned reserves, there was general agreement that in the longer run some new form of international reserve assets might possibly be called for. But it was made clear that a long-run view is involved, and that the decision to undertake the study implies no commitment as to its findings.

As the Group of Ten Report indicates, discussion among the Deputies centered around two types of proposals: (1) The establishment of a collective reserve unit (known as the CRU) among a limited group of countries, presumably the Ten; (2) The acceptance and development of gold tranche or similar claims on the IMF as an international reserve asset.

The CRU proposal would involve creation of this new international reserve unit, as a supplement to gold, in amounts to be determined by the participating countries. This proposal was probably developed from a plan first put forward over a year ago by Dr. Bernstein. In the plan considered by the G-10 Deputies, each country's share of these units would be determined by its gold holdings, relative to the total gold holdings of the whole group. Thus a country having 10 per cent of the total gold would receive 10 per cent of the units. Each country would agree to hold the new unit in fixed proportion to its gold holdings--that proportion being equal to the ratio of the total amount of the new units to the total gold holdings of the group. The process of re-establishing the agreed ratio, say every quarter, by exchanges of gold and collective reserve units among the members would assure that over time the composition of each member's holdings would seldom deviate very far or very long from the agreed fixed proportions. By unanimous agreement, the group could alter the total amount of units outstanding, as a method of altering their total holdings of gold plus collective reserve units--or alternatively, of preventing a change in that total.

Without attempting to anticipate the outcome of the work of the Study Group, I would like to explore with you some of the implications of this proposal. A major question that naturally arises as one looks at this approach is: Would the new unit supplement or supplant holdings of reserve currencies in the monetary reserves of the participating countries?

If it is intended to replace reserve currencies, it could be characterized as a proposal for a slightly modified gold standard in which gold-cum-units would be used to settle imbalances among the participating countries. Such a development would represent a sharp break with the evolution of the international monetary system, which has been moving away from heavy reliance on gold. There is also a danger that this approach would not be sufficiently flexible to provide for reserve increases at a rate adequate to accommodate the growth of world output and trade; for the procedure suggested for creating such units, involving individual member country veto, clearly implies a cautious and restrictive approach.

If, on the other hand, the scheme is intended to supplement reserve currencies, serious questions arise as to whether coexistence is in fact possible. Would not the basing of the distribution of CRU's--both at the outset and in later augmentations--give member countries an incentive to maximize their acquisitions of gold in preference to foreign exchange?

And how would the reserve currency status of the dollar be affected for countries outside the limited group? In general, what would be the impact of such a substantial departure from present procedure upon that important segment of total world liquidity consisting of reserve currency holdings (at present over a third of total reserves--inclusive of IMF gold tranche positions)?

A second and related question involves the size and character of the participating group. For a number of reasons, both political and economic, there are objections to abandoning a truly multilateral framework for dealing with world liquidity problems and confining such a scheme to the ten leading industrial nations. Leaving aside the political problems, a number of thorny questions would need to be resolved concerning the economic relationships between the in-group and the rest of the world.

The main alternatives to the CRU proposal would work through the International Monetary Fund, and would involve the creation of an international reserve asset in the form of gold tranche or other claims on the Fund. The IMF gold tranche--or more broadly, that part of the quota which is available on a virtually automatic basis--is an important example of the evolutionary possibilities that exist in the present international monetary system. For years, people tended to think of the gold tranche as fixed in amount, without paying much, if any, attention to the rising gold tranche positions of countries whose currencies were being drawn by other countries. These positions are reserve assets in a very real sense; since 1957 the United States has been able, in financing its own balance of payments deficit, to utilize roughly \$1.7 billion of its gold tranche. Most of the amount so used originated in previous dollar drawings by other countries, not in the U.S. gold subscription. And the United States is not the only country to have become aware in this way of the very tangible value of the gold tranche as a reserve asset.

Thus, semi-automatic claims on the IMF may and do originate from regular Fund transactions. But they could also be deliberately created. Two of the main techniques for doing this would be, first, to allow member countries to substitute, in connection with quota increases, something other than gold, such as a gold certificate, for the "gold tranche" portion of the increase; and, second, to make a larger portion of the quotas nearly automatic. Either of these techniques could be applied to all member countries across the board, or selectively on the basis of certain criteria; but even uniform application to all members would be selective in effect, because countries that had already drawn beyond some point in their quotas would not benefit--at least, not immediately.

Either of these techniques would utilize familiar mechanisms of the Fund, and would not be expected to have marked repercussions on the use of reserve currencies, or on the composition of reserve holdings. They would clearly be a supplement to the existing monetary system. There are, of course, some problems even in these techniques, but they have the advantage of developing rather naturally from familiar Fund policies and mechanisms.

Another main technique of reserve creation through the Fund would be via Fund investment, of one sort or another, in member countries.

This approach would be a more marked innovation, and would raise more complex problems.

All I wish to suggest at this point is that various means for expanding reserve creation through the IMF exist, and will receive careful consideration in the Study Group as well as in the Fund itself. If it becomes desirable to adopt a new approach to reserve creation, there is much to be said for using the already-tested Fund framework and for extending that framework, if and when necessary, in the light of experience gained.

Concluding Comment

This brings me full circle in my brief attempt to capture some of the flavor and substance of the Report of the Group of Ten. I began by emphasizing its contribution to the evolutionary development of our international monetary mechanism, and this is indeed the essence of the various ingredients in the Report. It visualizes a monetary system marked by even greater international cooperation, by expanded credit facilities largely centered in the International Monetary Fund and with bilateral facilities rapidly expansible in case of urgent need, by an improved adjustment process, and finally, if needed, by the provision of additional owned reserve assets--most appropriately, in my judgment, within the already tested Fund framework--as part and parcel of the full spectrum of availabilities that currently constitute international liquidity.