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The Quest for International Monetary Reform

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The Quest for International Monetary Reform

by J. Dewey Daane*

Every now and again my eight-year-old daughter Whitney ruins my day by saying "tell me about the olden days, Daddy." Today in this Zurich setting, in a country so rich in history and tradition, and with such a knowledgeable and sophisticated audience, I am not going to be so presumptuous as to try to go back to the "olden days" in terms of the international monetary scene. Specifically, I am not going to talk either about the collapse of the gold standard following the experience in the 1920's, when countries became unable or unwilling to sacrifice domestic growth to external stability, or about the ensuing decade of competitive devaluations. Nor am I going to look back and dwell on the glories of the Bretton Woods system, although they were in my judgment very real in terms of enabling an unprecedented expansion in world trade and payments over a quarter of a century. In fact, at one of the early meetings of the Committee of Twenty Deputies (the working group charged in the first instance with the present attempt at international monetary reform), many of those present traced the so-called "failure" of the Bretton Woods system not to inherent difficulties in the system itself, but to a failure in attitudes and behavior, in words such as "we failed it (the Bretton Woods system) more than it failed us" and "the failure

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was not a matter of texts but of their applications." This obvious nostalgia led one of my colleagues to say in an aside to me at the table, "it sound like we might as well resurrect the Bretton Woods system and gc home!"

But the reason why we cannot do just that is that the Bretton Woods system did, in fact, fail to assure either prevention or correction of serious imbalances in countries' balance of payments. Thus before looking ahead down the road of international monetary reform, we do need to look back and identify the deficiencies of what is known as the Bretton Woods system and try to take them into account in designing a new system. It is true that the difficulties of the system were exacerbated by the changing political and economic strength of nations and by the increasing emergence of massive mobile capital flows internationally. The Smithsonian Agreement of December 1971, involving an unprecedented multi-national exchange rate realignment, was undoubtedly a step in the right direction but obviously did not solve the basic problem of persistent substantial imbalances by both surplus and deficit countries. And while we believe that the rate structure that evolved from the agreements in February-March 1973 may well have represented a viable pattern of exchange rate relationships, despite all the market gyrations of recent months, it still left unsolved the basic problem of a better working adjustment process which is at the heart of the search for international monetary reform. And when I referred to the "nostalgia" for Bretton Woods, this simply underscores one of the key issues in our quest for international monetary reform: how to reconcile the desire for stability and the advantages of relatively fixed rates with the clear need for greater flexibility in adapting to the major changes that occur among nations as their domestic growth proceeds in new patterns at differing speeds.

For as we look back at Bretton Woods, it is clear that the objective was that of a stable framework for international economic transactions. Surely this was and remains a laudable objective. But the system itself proved to be too rigid in operation and in the end meant we were pursuing a surface stability superimposed on massive underlying change -- a pursuit that led to persistent crises and the eventual collapse of the system.

As I read international monetary history, the central failure of the Bretton Woods system was that it was unable to cope with the substantial imbalances that arose in the international payments positions particularly of the major industrial countries. Major imbalances did arise in the 1960's, and we now recognize, with the benefit of hindsight, that their origins can be traced back to the late 1950's. When payments deficits arose, the first reaction of the international community was to ignore them and hope that they would go away. The second step, when they did not go away, was to call upon the country with the deficit to take internal measures to set its house in order. Often such measures were adopted but they were frequently inadequate and sometimes inappropriate. In the end there would be a major crisis and a country would usually change its exchange rate.

There are three lessons to be drawn from this experience. First, attempts to assign responsibility primarily to countries in deficit for what were imbalances in the international economy at large were counter-productive; they did not induce national authorities to take actions that were politically unpopular. Second, those actions that were taken were often either inadequate or overly adequate, and were almost always adopted reluctantly and after long postponements. Third, the frequent result was international financial crises disruptive to the very stability that the system was intended to promote. In brief, therefore, the system lacked mechanisms that encouraged or ensured the process of adjustment of payments imbalances to take place smoothly and promptly.

Most of the other shortcomings of the Bretton Woods system were the direct or indirect result of this lack of an adequate, and a symmetrical, adjustment mechanism. For example, it is often argued that there has been inadequate control of the level, and some would add the distribution, of international reserves. But in a system where countries were not encouraged to take prompt adjustment actions, there was a continuing need for increases in international liquidity to feed the appetites of countries seeking increases in their reserves. As the system was structured, these desired increases in reserves could only be supplied through the deficits of the so-called reserve-currency countries. The expansion of monetary holdings of gold was inadequate and subject to the vagaries of chance; its supply could not meet the aggregate of countries' demands for reserves. And even when the special drawing rights facility was established in 1969, it was designed and viewed as a supplement to reserves.

Another indirect result of the inadequate balance-of-payments adjustment mechanism under the Bretton Woods system was that the system was not able to adapt to and absorb structural changes in the international economy. It was not recognized until too late that with the successful postwar reconstruction of Europe and Japan, and the re-emergence of these economies as outstanding features on the economic landscape, adjustments would have to be made if the international economy was going to evolve smoothly. Similarly, the rigidity of the Bretton Woods system made it difficult for some countries to give effect to the responsibility that they felt to promote the flow of resources to the developing countries of the world. Finally, the increased integration of the international economy -- and a volume and complexity of world trade and capital movements that would have been difficult for those at Bretton Woods, New Hampshire, in 1944 to imagine -- posed problems for the resiliency of the international monetary system that it was often ill-prepared to handle.

The first and paramount issue, therefore, in our quest for international monetary reform is to agree upon mechanisms to improve the working of the balance-of-payments adjustment process. If a new international monetary system is to prove workable, such an agreement must not only promise a satisfactory adjustment process but deliver on that promise. Without the assurance that countries will be induced to make the difficult decisions to take adequate adjustment actions promptly -- and that may mean domestic actions, or exchange-rate changes, or both -- any agreements on the other issues being debated as we search for monetary reform, namely the relative roles of various reserve assets, convertibility, consolidation and the like, will not survive.

In the quest for reform, then, attention has of necessity centered on the so-called adjustment process. The discussions in the Committee of Twenty both at Deputy and Minister level have reflected this central concern; it has generally been the first agenda item. A reformed international monetary system must have a mechanism that is based upon the principle that countries both in surplus as well as in deficit have a responsibility in the interests of the system as a whole to take adjustment actions when they experience a sustained payments imbalance. In the past, there was a tendency for each country to try to assign the guilt or responsibility for its imbalances to another country or group of countries. Most often in fact the fault lay in the system as a whole. The system needed effective policy actions not a judicial decision as to allocation of blame. What is needed now is to find a "no fault" mechanism to guide the adjustment process in the reformed system. What we have been advocating and seeking is symmetric responsibility.

The reformed international monetary system must also have a mechanism that encourages countries to take adjustment actions promptly and in as non-disruptive a manner as possible. If the large imbalances of the past are to be avoided, then all countries must be prepared to move more quickly to avoid their renewed build-up. If the reformed international monetary system is to avoid the crises of the past, then countries will also have to be encouraged to avoid abrupt changes in policy. In a world in which policy actions tend to come in large and discrete doses and responses are subject to long lags, this will be an objective that will be difficult to achieve, but we should not stop trying. As a general rule, it can be said that the earlier a needed action is taken, the less drastic it will have to be.

Most of these principles regarding the adjustment mechanism in the reformed system have been accepted by participants in the reform discussions. We have all learned the lessons of the past quite well. The difficulty arises with trying to give the lessons operational content in the reformed system. As is well-known, the United States believes that indicators based upon countries' official reserves should be used to help guide and ensure the smooth functioning of the adjustment process. We have favored indicators because their use would encourage a more responsive, more certain and symmetrical system of adjustment. We have favored indicators based upon reserves because data on countries' reserves are least ambiguous, most comprehensive, and more quickly available than other series. Even more fundamentally the focus on reserves seems to be the most appropriate indicator in a system with general convertibility. Since convertibility relates directly to reserves it makes sense to us to look to reserves as the principal guide to activation of an adjustment process.

The question -- and I think this was clarified after the Washington meeting of Ministers in July -- is not one of tying the adjustment process to an automatic system of reserve indicators. The international economy is much too complex for such a simplistic solution. In any approach to reform there is a necessary role for international consultations; there must be an opportunity to second-guess constructively the reserve indicators and bring other information to bear on the interpretation of particular cases of imbalance. On the other hand, the adjustment mechanism in the reformed system must have backbone. It must have the means of inducing countries in surplus and deficit to take actions to correct their payments imbalances. It must have a means of not only focusing the attention of responsible officials but of actually keeping the international economy on track.

One of the ways in which the reformed system can have focus is to have a regime of par values as the center of gravity. The formula endorsed by the Committee of Twenty, "stable but adjustable par values with provision for floating in particular situations," is open to conflicting interpretations. But it recognizes the importance of having countries follow responsible exchange-rate policies. Our present experience with floating exchange rates indicates that such a system as a permanent feature of a reformed system would create greater complexities in terms of required rules than governments are prepared to deal with on a long-term basis. Generalized floating is no answer to the problems of the proliferation of controls. And the recent experience suggests that floating rates in practice do not in themselves solve the deficiencies of the Bretton Woods system in terms of the adjustment process. However, resort to floating rates may well prove useful in particular situations, and consequently, much more attention needs to be given to the rules accompanying such floats.

Once there is assurance that the reformed international monetary system will embody mechanisms to ensure the effective working of the adjustment process, it will become much easier to deal with other aspects of reform in a realistic and constructive manner. What are these other aspects or issues that are involved in the quest for international monetary reform? In brief, I think the other main issues are (1) convertibility and settlement, (2) the role of the primary reserve assets, more particularly gold and SDRs, and (3) how best to assure adequate development assistance.

On the first issue, namely that of convertibility, a number of countries have stressed the importance of restoring some sort of convertibility in the reformed system and in the process obtaining greater control over the growth of international reserves. The United States has assumed a system of general convertibility in which each country maintaining a par value or central rate would stand ready to convert any holdings of its currency by a foreign central bank into primary reserves (or the currency of the country requesting conversion). All countries would have the same obligation to assure convertibility of their currencies, and all would have the right to present holdings of another country's currency to the issuing country for conversion. In order to ensure that no country in chronic surplus could place inordinate strains on the system by obtaining too large a share of the world's limited stock of reserves through the convertibility mechanism, we would place limits on the right of each country to accumulate primary reserves. Such limits would be related to the overall availability of primary reserves in the system and agreed guidelines as to the distribution of reserves among countries.

In short, a system of general convertibility cannot be sustained unless it is supported by an adequate adjustment process and by adequate reserve creation. However, a reformed international monetary system will still be subject to periodic stresses and strains. Consequently, we have expressed reservations about instituting an overly rigid system for the settlement of any and all imbalances that should arise. In our complex international monetary economy there can be abrupt changes in tastes and shifts in private portfolio preferences and it would be unrealistic to assume that in a reformed international monetary system there will not be the potential for substantial international movements of private capital. Unless there is sufficient flexibility in settlement arrangements to absorb such shocks the system will break down no matter how efficient the adjustment mechanism may be over the long run. Certainly from our viewpoint controls over capital movements are not in the long-run interests of the international economy -- and, in the complex financial system of the U.S. such controls are neither feasible nor desirable.

As to the second major issue, that of determining the composition and supply of official reserve assets, a reformed system must contain the ability to create adequate international reserves rationally and to allocate them among countries equitably. On this complex issue, reform of the international monetary system preferably should, and will, be evolutionary rather than revolutionary. As I view the matter, the recent gyrations in gold markets make it crystal clear that it would be a mistake to try to reverse the process now underway of gradually phasing the role of gold down and out of any reformed system. This process has been taking place in national economies as well as the international monetary system for over a century. There are no good reasons for halting or reversing the process, although the emotional attachment of some to gold cannot be completely ignored. Even central bankers sometimes seem to be afflicted with this emotion. For my part, I find myself in agreement with your June speaker, Dr. Lutz, if I rightly understand his position, namely, that it would be, as he put it, "a sensible arrangement" for central banks to be allowed to sell gold in the free market, and that ultimately "it seems just as well that the last step of a complete demonetization of gold should be taken."

Related to this issue of the role of reserve assets there seems to be general recognition in the so-called "reform exercise" that the relative importance of the foreign exchange component of countries' reserves should also be reduced over time. On this issue it _is_ a question of reversing a process that had evolved over a number of years. Some countries obviously feel that it is important to use and hold reserves in the form of foreign exchange and would not want to be deprived of that privilege. Moreover, the possibility of holding such reserves provides individual countries and the system as a whole with an added element of flexibility in the settlement of imbalances that may still be a useful adjunct to the functioning of the system.

Clearly, however, the result of phasing gold out of the system, and of restricting the role of reserve currencies, points to the greater absolute and relative importance of special drawing rights as the central reserve asset in the reformed system. Confidence in such an asset is crucial to its development and expanded use. Our desire to foster such confidence is one of the reasons why we have had reservations about the so-called development assistance link. As we see it, a direct link between creation of SDRs and development assistance would neither benefit the SDR's central role in reform nor add significantly to development assistance. This does not minimize the importance to us of the third issue, that of adequate development assistance. Quite the contrary. It simply underscores the necessity of finding other ways to resolve this vital issue.

Finally, a successful quest for international monetary reform must deal with the legacies of the past. One such legacy is that of the outstanding stock of currencies held by foreign governments. In the Committee of Twenty deliberations it has been proposed that some or all of these dollars and other currencies should be consolidated one way or another. I would like to make one simple point on this issue, namely, that the costs and benefits of such consolidation require careful weighing. Any solution to the so-called dollar overhang should recognize the interest of the system as a whole, and the terms upon which any consolidation takes place should be specified accordingly. The best way, of course, of dealing with the dollar overhang problem is to insure that there is provision for the United States to earn back these dollars through balance-of-payments surpluses in the future.

As we meet here today on the eve of the Annual Meetings of the Board of Governors of the International Monetary Fund and the World Bank in Nairobi later this month, you may well ask where negotiations stand on these various issues confronting us in our quest for international monetary reform. On the crucial issue of the adjustment process I believe that there has been a narrowing of differences and certainly a much greater understanding. There seems to be general recognition and acceptance of the need for symmetry in terms of the burden of adjustment and willingness to try to design a workable system. Differences do remain with respect to the degree of presumption of action involved in the use of reserve indicators. Much work remains to be done on the issue of primary reserve assets, particularly with respect to the character of the special drawing right as it assumes the role of the central reserve asset in the reformed system.

Given the complexity of the issues and the diversity of interests, the Nairobi meeting cannot be expected to produce definitive conclusions on all these issues. But it may well produce some agreement on principles in a general outline of a reformed system. We can hope to see in such a statement of principles a broad framework for a workable reformed system: in particular, the promise of an adjustment mechanism that will prevent the large imbalances and crises of the past, a system of settlement that will take into account the interests of a diverse group of countries as well as the system as a whole, clear recognition that the SDR's role will be at the center of the reformed system, and indication of the ways to take care of some of the legacies of the past.

The next order of business is to get down to the practical aspects of the reformed system. All countries are very interested in examining the operational implications of the various reform proposals. For my part, I am sure that the United States' representatives are looking forward to participating in, and an early resolution of, this process.

On my vacation this summer up in Michigan I saw a movie of the musical show "Man of La Mancha" in which the song entitled "The Quest" otherwise known as "The Impossible Dream" is central to the theme of the play concerning Don Quixote's search for a seemingly unattainable goal. In the meetings we have had since last September both of Deputies and Ministers of the Committee of Twenty, looking forward to a revised international monetary system, there has often been much of the same feeling of unreality and impossibility of achievement. But even more often there has been a feeling of working closely with our counterparts from other countries in seeking to achieve a real and constructive result. Not too long ago my daughter Whitney at breakfast one day rather shook me up by asking, "How old are you, Daddy?" In order not to frighten her completely, I prevaricated a bit and said, "Oh, around 50." She then asked, "And when I'm around 50, how old will you be?" Again, I said, "I would be near a hundred." She persisted and asked me, "When I'm near a hundred, how old will you be?" To that query, I responded, "You know, Whitney, I think the practical possibilities of either one of us living that long are not very great." She thought for a moment and then looked up at me and said, "Well, we can try, can't we, Daddy?"

Just so on the issues of international monetary reform. Despite the seeming impossibility of finding workable solutions to the various problems of international monetary reform we can and must try to do just that. There can be no moratorium in our quest for a new and stronger and better-functioning international monetary system. On this score, I am very much heartened by the most recent meetings of the Ministers of the Committee of Twenty held in Washington at the end of July, and last week's meetings in Paris of the Deputies carrying forward the thrust of the Ministers' meeting. The end of July Ministers' meeting was billed in advance as a working meeting, without a communique, to permit a frank and useful exchange of views on the key issues which I have already summarized for you. That end-July meeting certainly lived up to its advance billing. It was a good, constructive meeting and definitely forward looking toward workable solutions. The Chairman of the Committee of Twenty, Ali Wardhana, summed it up well in both privately and publicly lauding the "constructive spirit in which the Committee had faced the difficult decisions before it." Indeed, as we continue our search for international monetary reform, the international monetary cooperation we have experienced, and are experiencing, seems to me the most important augury for success. Given the complexities of the international economy, international cooperation is not only crucial to a successful quest for monetary reform but must also continue to play a central role if the system is to work smoothly. In this sense it might well be said that the quest for international monetary reform should never end.