FOR RELEASE ON DELIVERY
FRIDAY, SEPTEMBER 12, 1975
1:00 P.M. EDT

THE EVOLVING INTERNATIONAL MONETARY SYSTEM

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Atlantic Economic Conference

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Washington, D.C.

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The Annual Meeting of the International Monetary Fund has just come to an end. This is a good time, therefore, to review the ongoing evolution of the international monetary system.

Two important issues in this evolution were before the meeting: (1) the role of gold and (2) the exchange rate regime. An agreement was reached on gold, subject, however, to agreement being reached also on the exchange rate regime, which it is hoped will be settled at the Fund's Interim Committee meeting in January. Agreement was reached also on the enlargement of IMF quotas, subject to the same condition.

Gold

There is overall agreement, resulting from the work of the IMF Committee of Twenty (CXX) and reaffirmed at the IMF Interim Committee meeting in Paris last June, that the role of gold is to be reduced.

This is reflected in the two principal points of the agreement now reached in Washington: an aggregate ceiling on official gold holdings including those of the IMF, and a prohibition on attempts to peg the price of gold.

To ensure that the future will move in the direction of further reducing the role of gold will require, however, the continued vigilance of the participants. Since the agreement does not prohibit trading in gold among governments and central banks -- a major concession by the United States -- such sales and purchases could resume once the Articles of Agreement of the IMF, which now prohibit central bank purchase of gold above the official price of about $42.24 per ounce have been amended. This process, including legislative ratification, might take 18 months.

It is obvious that there could exist forces and circumstances could come into being that would make a reduction in the role of gold more difficult. At a minimum, some countries would like to see the price of gold remain high, because they have large official holdings, or because their nationals have large holdings, or because, like the developing countries, they stand to gain from the sales of gold that the IMF is to make from its own holdings for their benefit.

Beyond the desire for a high price, there may be a wish in some quarters to return gold to its erstwhile status as the major reserve asset, resuscitating it from the secondary or tertiary liquidity role that it has played of late. This would mean an enormous increase in international purchasing power for large gold holders. Technically, such a restoration of gold to the center of the international monetary system could be achieved without a return to the gold standard proper, i.e., without pegging national currencies to gold. Pressures for a return to fixed rates, however, could also push the system in the direction of a return to a gold standard. The consequences of such a move would be very adverse. This should be obvious in view of the unreliability of supply and demand for gold and enormous inflationary potential that is inherent in gold profits by national treasuries and an increase of international monetary reserves by about one-half.

Fortunately, a return of gold to the center of the system, and even more a return to the old gold standard, is unlikely. Even if the agreement not to peg the price of gold should terminate after two years, as might happen under the terms of the Washington agreement, it would still remain risky for central banks to buy or sell gold. Fixing an official price near the level of the market would not remove the difficulties, since central banks would not want to sell at the official price when the free market price was above it nor to buy at the official price when the free market was below it. To try to fix the free market price, on the other hand, would require at least one official holder to buy and sell without limit. This has been tried before and was given up in 1968, leading to a split price and the immobilization of official gold reserves.

There is a good probability, therefore, that intergovernment transactions in gold will remain limited to the use of gold as collateral under loans, as has been the case so far. Of course, this would not preclude sales to or purchases from the market by individual governments or central banks, subject to the aggregate ceiling and the amendment of the IMF Articles that now preclude purchase of gold above the official price. Gold could also be bought from the IMF at a market-related price, subject to the same conditions.

In summary, the Washington agreement has left in being some conflicting forces concerning the gold issue. That is not surprising, given that there have been strong differences of views. But the defects of a gold-oriented system are obvious, and are clearly recognized in most countries. It would take serious failure of the existing system, and a general decline in the world's faith in paper money, to make a return of gold to the center of the system at all likely.

Exchange Rate Regime

A second major choice for the international monetary system is that between an orientation toward floating and one toward fixed rates. Since at the present time it is hard to visualize a practical alternative to floating for most developed countries, some people argue that this is a theological issue. They imply that, if some other country wants to write some kind of obligation to return to fixed exchange rates into the amended Articles of Agreement of the IMF, the United States might as well agree, because such a clause is likely to remain a dead letter. That would be a shortsighted as well as morally indefensible attitude for us to take.

Commitments of this sort have a way of arising -- or being brought up by others -- to plague those who have rashly made them. Moreover, the amendments to the Articles of Agreement, including the widely desired quota increase and decisions concerning gold, must be approved by the U.S. Congress. If the Congress insists on a free and unqualified option to float, the United States needs a provision in the Articles that assures this.

It can be argued, without stretching the point very much, that the Committee of Twenty formula calling for "stable but adjustable par values with provision for floating in particular situations" takes care of this need. The United States, considered as an "optimum currency area," finds itself in a particular situation that makes floating desirable. But the particular circumstances that make floating and fixed rates, respectively, preferable have unfortunately never been spelled out.

The issue apparently was assumed to hinge on whether prices and other relevant variables are sufficiently stable to permit exchange rate stability. The question whether there are particular countries whose structure predisposes them to float has been examined only at an academic level. It has been argued that countries producing primary products whose prices fluctuate widely are in need of greater variability of exchange rates than others. It has likewise been argued that small countries, whose international economic relations bulk large relative to the domestic economy, are more in need of stable rates than large countries with a relatively small foreign trade sector. Failure to examine these matters carefully is responsible for part of our present lack of agreement on whether the right to float should be unqualified or should be subjected in some form to the judgment of the IMF.

Lack of a clear understanding of these issues is not the only source of disagreement about the optimal choice among exchange rate regimes. Recent experience with floating has also had an impact. Exchange rate fluctuations have been much wider than could be justified by any conceivable variation in longer term equilibrium rates. Changing expectations concerning inflation, movement of OPEC funds, and other hard-to-foresee developments are in part responsible. But changing interest rate differentials, which are an inevitable concomitant of internationally divergent phases of the business cycle, also have played a major role. Exchange rate movements of this kind have been expected to be kept in check by stabilizing speculation. But stabilizing speculation has become risky. The banks, some of whom initially seemed to incline toward this activity, have learned from experience that it is a dangerous game. They are being warned away from it in any event by their regulators. Large corporations are not in the business of speculating in foreign exchange any more than they can help it. As a result, exchange rates can and in fact have fluctuated widely as interest rates have moved.

Many businessmen have said that they would rather live with fluctuating rates in well-functioning markets than with fixed rates exposed to perennial crises and the threat of controls. But movements of the order of 10 per cent within a few months between major currencies can play havoc with profit margins. Reports from the German automobile industry and the Swiss watch industry make that point. In time, continued fluctuations of this magnitude may well induce firms that have an established market abroad to supply that market by establishing local sources of supply, i.e., through foreign investment, rather than through exports. This seems all the more likely when a foreign producer who tries to hold on to his market share by maintaining a competitive selling price is accused of dumping when his home currency appreciates.

The actual level, as contrasted with the variability, of exchange rates no doubt has also shaped national reactions to floating. To the rational economic policymaker, an undervalued rate has as many disadvantages as an overvalued one. He would like to see an equilibrium rate, if he could define it. But political reactions and pressures flowing from overvalued and undervalued rates may be very different. An overvalued rate causes loss of jobs in export industries, while also helping contain inflation. Political reaction to this may be much more adverse than response to an undervalued rate which helps jobs and export profits while its tendency to raise prices is overlaid by other inflationary factors. So far, the European countries with their strongly appreciated rates have been at the high pressure end of that scale. For the United States, whose exports have been rising dramatically, faith in the virtues of floating has not recently been tested by a similar situation.

The ups and downs of floating rates, in any event, must not be allowed to obscure the fundamental case for floating in an economy like the United States. Being large inside but relatively small outside, like the ideal automobile, the United States comes close to being an optimum currency area. For such an area, if anywhere, the case for floating is strong. Even though I could visualize conditions in which fixed rates would be preferable, these conditions do not prevail now, and nobody can say whether they will ever return.

There are, of course, other considerations for the United States beyond the simple proposition that a large country finds it in its interest to float. Greater domestic stability for the United States will work also for the benefit of the rest of the world. The United States, moreover, has always felt a responsibility for the well-being of the rest of the world, in which it must live and whose condition reflects back on the United States. This responsibility is expressed in the Articles of Agreement of the International Monetary Fund concerning exchange rate arrangements, which to the extent that they still seem applicable to the present situation, require collaboration with the Fund in exchange matters. These are responsibilities that the United States cannot fail to recognize.

Smaller countries, more dependent on foreign trade, may find fixed rates more attractive. They can choose, however, between a higher degree of exchange rate stability with their main trade partners and a lesser degree with all the world. The countries of the European "Snake" have opted in the first direction. The Snake has exhibited considerable drawing power. France, which had left it, has returned, Switzerland is eager to join, Austria maintains a fairly stable relationship without formal membership.

This evolutionary process may be creating a new optimum currency area in Europe. Its economic structure will then resemble that of the United States, big inside, small (though bigger than the United States) outside. It will then not be in the interests of the area as a whole to seek fixed exchange rates with the rest of the world. That would subject its members to a balance-of-payments discipline that their relatively small economic interdependence with the outside world would not justify.

If the world cannot sustain a fixed rate system, then the formation of optimum currency areas, in which countries float jointly, may be the best arrangement, provided it does not lead to controls. From the point of view of the members of the Snake, therefore, as well as from that of the United States, an attempt to return to fixed rates outside the Snake will probably come to be seen as inadvisable.

The recent argumentation in favor of a move toward fixed rates has largely abstracted from this kind of economic analysis. It has proceeded also without the benefit of examination of some of the technical issues involved. These issues were explored with a high degree of sophistication by the CXX which concerned itself particularly with the problem of the adjustment mechanism and the control of liquidity. The current discussion also abstracts from the question of how to get from one fixed exchange rate to another without market upheavals when fundamentals change, a perplexing matter with which the CXX failed to come to grips.

The case made for fixed rates has failed to specify the medium in terms of which rates are to be tied. SDR do not exist in sufficient volume. Gold is out of the question. That leaves only the dollar to which other countries could peg their currency with a wider or narrower margin. But the dollar is inconvertible, and an inconvertible dollar standard hardly seems acceptable for the rest of the world, even if the United States were willing to give up the right to have its exchange rate determined by its own policies or by market forces. To make the dollar convertible, on the other hand, would not be acceptable to the United States if it implies an unwanted degree of balance-of-payments discipline, even if a technique could be developed, such as through some noninflationary creation of SDR or through U.S. borrowings of foreign currencies.

The United States has been convertible much of the time since World War I. But in one way or another it has usually been shielded against severe balance-of-payments discipline. During the 1920's, the dollar was strong because Europe was still recovering from the war. During the 1930's, when other countries devalued or otherwise put pressure on the dollar, the United States also devalued and once more developed a strong balance of payments. During the 1940's and part of the 1950's, the United States was shielded by the "dollar shortage." Domestic policy was responsive to balance-of-payments pressure during the late 50's and early 60's, and I do not believe that "benign neglect" was a proper description of U.S. attitudes at any time, then or later. Through various *ad hoc* measures, however, including controls and *de facto* restraint of gold exports, the United States sought relief from balance-of-payments pressure and, after two formal devaluations, ended up with a floating currency. The historical record, whether one agrees with the policy decisions that were made or not, speaks very clearly.

Liquidity

In addition to the issues of gold and the exchange rate regime, which have occupied official attention of late, the evolution of the system has created other important concerns. One of them is liquidity. World reserves, during 1974, rose by $36 billion or better than 20 per cent. Since the value of world import over the same period rose by 36 per cent, however, the ratio of world reserves to imports fell to a new low of 24 per cent, contrasted with 29 per cent in 1970 and 50 per cent in 1960. By this familiar measure of liquidity, therefore, world liquidity declined, especially taking into account the fact that almost the entire increase in reserves occurred in the hands of OPEC countries. Only as these countries spend their reserves will the liquidity of the rest of the world be affected.

These data leave out of account, however, the rise in the free market price of gold, gold holdings being computed for reserve purposes at the old official price. Restating official gold holdings at a price of $150 per ounce would raise reserves by almost $100 billion to $329 billion. The liquidity of gold reserves, of course, remains limited, given the uncertainty about the price at which it can be sold.

The supply of reserves in the existing system is essentially open-ended, i.e., reserves are demand-determined. Any country, by buying foreign currencies, especially dollars, can increase its reserves. If at the time its exchange rate is rising, such purchases will limit the rise, if falling, they will accentuate the decline. By the same token, countries can reduce their reserves by selling and accepting the resulting upward exchange rate bias.

The level of demand for reserves today is likely to be influenced downward by the fact of floating and by the relative ease with which reserves can be borrowed in the international market, and in an upward direction by the uncertainties created by the oil problem. The decision of countries with deficits to borrow rather than to reduce their reserves suggests that these countries did not regard their liquidity as excessive.

Nevertheless, the fact that world liquidity, especially as manifested in sources of liquidity such as the Eurocurrency market, is not evolving toward any meaningful system of control remains a matter of serious concern. Excessive international liquidity probably was in part responsible for the worldwide inflation of recent years. Past efforts at international monetary reform, including the creation of the SDR, the CXX exercise, and the decision to reduce the role of gold, all had as one of their objectives a better control of international liquidity. This objective still eludes us.

Under these circumstances, it is not surprising that no new issues of SDRs have taken place. It is not only concern over the "Link" proposal that has stymied the SDR, but also concern over excessive liquidity creation. This concern, on the other hand, has not stood in the way of an agreement to expand conditional liquidity through a quota increase of 32.5 per cent in the IMF that more or less keeps pace with the rate of inflation in the industrial countries.

The SDR is making progress, however, as a numeraire. Some currencies are being pegged to it, although reserves, official intervention, and other transactions remain in dollars or other currencies. A few bond issues and even bank deposits are being denominated in SDR. Thus it becomes apparent that SDR can be "created" by the banking system like any other form of money, even though such privately created SDR balances are entirely separate from the SDR system operated by the International Monetary Fund.

What I have said should suffice to make clear that the international monetary system is indeed evolving. Its evolution goes forward partly under the influence of events, partly guided by negotiations and decisions of governments. There is ground for satisfaction in the ability of the system, so far, to avoid moves in clearly undesirable directions, such as toward widespread controls. There are grounds for concern about the lack of control of liquidity, including the potential remobilization of gold, and the lack of full agreement over where the system should go. Continued vigilance and strenuous negotiation will be needed to make sure that evolution continues to mean progress.

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